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S. Hrg. 103–202

# HOW SECURE IS YOUR RETIREMENT: INVESTMENTS, PLANNING, AND FRAUD?



## HEARING

BEFORE THE

## SPECIAL COMMITTEE ON AGING UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC

MAY 25, 1993

**Serial No. 103–8**

Printed for the use of the Special Committee on Aging

U.S. GOVERNMENT PRINTING OFFICE

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## APPENDIX

# HOW SECURE IS YOUR RETIREMENT: INVESTMENTS, PLANNING, AND FRAUD?

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**TUESDAY, MAY 25, 1993**

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
*Washington, DC.*

The Committee met, pursuant to notice, at 9:30 a.m., in room 628, Dirksen Senate Office Building, Hon. David Pryor (Chairman of the Committee) presiding.

Present: Senators Pryor, Cohen, Craig, Kohl, Feingold, Grassley, and Simpson.

Also present: Gregory Smith, chief counsel; Christine V. Drayton, chief clerk; Jennifer Green, staff assistant; Mary Berry Gerwin, minority staff director; and Helen M. Albert, investigator.

## OPENING STATEMENT OF SENATOR DAVID PRYOR, CHAIRMAN

The CHAIRMAN. Ladies and gentlemen, we want to welcome all of you this morning to our hearing. We have entitled our hearing of this morning "How Secure Is Your Retirement: Investments, Planning, and Fraud?" It is becoming increasingly obvious that the problems of older Americans are very complex.

Our hearing this morning will look at one of the many concerns older Americans face, and that is, their retirement. In today's world retirement is much more than deciding what to do with your leisure time. There are many decisions that have to be made before the elderly can begin to think of leisure activities. One of the most important decisions to be made is how will one finance or supplement their retirement.

The economic view of various segments of society concerning low interest rates reflects the varying financial needs of the U.S. population. Corporations, younger, and middle-aged Americans generally hail such interest rates as good news when they are lowest. In many instances, however, older Americans on fixed incomes may receive the news of falling interest rates with great dismay.

Often, they stand to be major losers, particularly if they use their investment income to finance or supplement their retirement. In these situations, seniors confront a tough choice, either invest in bonds that carry higher interest rates but are uncomfortably long-term for people of advanced age, or they invest in bonds or stocks that carry greater risks.

The decline in interest rates affects seniors financially, but it also raises issues of emotional well-being, quality of life, finding strategies to avoid or ride out the low-interest phenomenon, and maintaining one's independence.

Even the most sophisticated among us can become confused by having to choose from among different types of life insurance policies or by having to decide whether or not to invest in stocks, bonds, certificates of deposit, or money market funds. These choices become even more difficult for seniors when there are people trying to take their money.

Financial fraud and/or abuse that targets the elderly or disproportionately affects them is a serious threat to obtaining a secure retirement. Low or declining interest rates cause seniors to look for new investments to increase their rate of return, which in turn makes them much more susceptible to fraud. This type of fraud or abuse may exist in many forms, whether it is outright misrepresentation of the facts or investments that are unsuitable for older investors.

Today we will find out what are some of those abuses that have occurred, what to look for, and how do we report those abuses. The States have taken the lead in addressing these problems, principally the State security administrators. We have with us today three security administrators who are addressing elder investment fraud. Nationwide, States have done a fine job in confronting this issue. I want them to know that they are not alone in this fight. We are going to hear their thoughts on how we might better work together in a cooperative spirit between the Federal and the State governments.

Whatever form we find it, investment fraud is devastating especially to our older citizens, many of whom are at moderate- to low-income levels with limited knowledge of financial or investment matters. We look forward to hearing from our witnesses today. We are also going to hear from two witnesses who have been victimized by some of the fraud that is so prevalent in our society.

The CHAIRMAN. I will yield at this time to my colleague and vice-chairman, Senator Cohen.

## STATEMENT OF SENATOR WILLIAM COHEN

Senator COHEN. Thank you, Mr. Chairman.

Let me endorse completely what you have just said, and point to the fact that the minority staff has been working on this issue for some time, to bring to the attention of the American people the dangers that our elderly community face.

As you pointed out, Mr. Chairman, as our elderly community look at the low interest rates now being offered in bank accounts, they are seeking other alternatives. They know, for example, that certificates of deposit are available, that they are safe, but that they are long term. They fear tying up their money in long-term CDs in case they have an emergency; maybe an operation, or perhaps to pay for expensive drugs, medications, or other types of emergency situations.

So they are very reluctant to tie their money up now in CDs. They are really confronted with a bewildering choice of sales representatives, brokers, professional financial advisors, and they're not sure what the distinction is. I'm not always sure what the distinction is, and perhaps we'll determine what those distinctions are.

But nonetheless, they are confronted with outright con artists, unscrupulous or incompetent investment advisors. And the elderly community is particularly vulnerable. Many receive lump-sum retirement benefits. They've got a lump sum that's available and may be a target for these particularly unscrupulous people who are targeting the elderly. Most live on fixed incomes, and they need to live on that retirement benefit, or their savings, which may have to last them 10, 20 years or longer. And yet they now become the targets of those who want to rob them of that saving.

We're going to hear from State security administrators, today, as you have indicated. In my own State of Maine, I might point out, we are not immune from this type of harm. We have one instance, a stockbroker who is now awaiting sentencing on a fraud conviction in the Federal District Court in Portland, for setting up a phony trust fund and inducing a number of elderly savers to invest in what he termed safe, high-yielding investments. His retired customers had invested large portions of their life savings into a bogus trust fund, only to lose substantial sums of their money.

And of particular concern to me is the case of First Investors. It's a large mutual fund company which at one time had offices in a number of cities throughout Maine, and currently is being sued by the State of Maine for alleged deceptive sales practices. And we're going to hear from one of those victims today.

Many savers, and other small investors, were allegedly sold mutual funds without regard to their level of understanding or ability to bear the risk, and tragically many of these cases resulted in senior citizens losing thousands of dollars in their savings. And I'll give you just a couple of examples provided to me by State regulators, Mr. Chairman.

In 1991, an 86-year-old husband and 79-year-old wife from Standish, Maine, invested $29,000 into one of First Investors' high-yield funds and approximately a year later had allegedly lost $10,000 of their investment. They state they had no knowledge that the funds were invested in junk bonds.

An Ashland, Maine couple, who at one time had been farmers and after a bad crop went to work at a paper mill, invested their lump-sum distribution of $18,000 and an IRA of $8,000 into a First Investors fund. They told the salesperson that this was the only money they would ever have and must be careful not to lose it. They were allegedly assured that the investment was safe and guaranteed to be better or just as good as a bank. Unfortunately, this was not the case. Instead of earning money, they allegedly lost about $9,000 of their total life savings of $26,000.

A Presque Isle couple in their sixties, the husband was a heavy equipment operator for a paper company, and his wife was a grocery store clerk, invested $28,500 and were allegedly told by the sales representative that the investment compared to a bank account, only it had more benefits. They allegedly lost several thousand dollars in that case.

And finally, a shop foreman from Dover-Foxcroft and his wife, who worked in a shirt factory, allegedly lost $4,600 of their $15,000 after being told by the salesperson that there was nothing to worry about, that their investment would be protected.

I won't take the time this morning, Mr. Chairman, to go on further. But approximately 5,000 First Investors accounts were opened, with overall losses conservatively estimated to be in excess of $1 million. And this is only in the State of Maine. It goes much further when you consider the other States involved.

So Mr. Chairman, we are pleased that you are conducting the hearing to try to come to grips with the problem confronting our elderly today as they try to provide for their so-called golden years. They are finding that there are many people out there who are targeting them with unscrupulous and misleading, deceptive tactics, or finding that they are disproportionately victimized. We hope not simply to present more legislation. I'm not satisfied that we can legislate in this field.

But we have to have much greater oversight by those who are responsible for regulating this particular industry. An the chart we have up there, I think, is very good advice for all the senior citizens who might be watching. Don't buy investments over the phone, demand a prospectus, read it, above all, do your homework, check the broker's record, define your own investment objectives, get assurances from the person that you are dealing with in writing that he will meet those objectives, don't give control over to other people, and read the statements. This is a pretty good listing of commandments to those who are about to give up their money to people who profess the make their money grow in the future.

I ask unanimous consent that my full statement appear in the record.

The CHAIRMAN. Without objection, your full statement will be printed.

[The prepared statements of Senator Cohen, Senator Richard Shelby, and Senator Larry Pressler follow:]

PREPARED STATEMENT OF SENATOR WILLIAM S. COHEN

Mr. Chairman, I am pleased that the Committee is holding another in our series of hearings on consumer fraud against the elderly. For the past several months, the Minority staff has been investigating the growing problem of investment fraud and abuses which target senior citizens, often robbing them of their retirement savings.

Many older Americans, in order to make ends meet, rely on investment income to supplement pension payments or Social Security benefits. Current low interest rates are forcing many seniors to look for alternatives to traditional saving accounts and money market funds. Retirees know they can invest in CD's with long periods of maturity, but they are reluctant to tie up their money, fearing they may have to tap into their savings for a major operation, expensive drugs or some other emergency. As a result, more and more senior citizens are investing in mutual funds and other securities to supplement their income.

Faced with a financial services environment that has become increasingly complicated, older savers are turning to sales representatives, brokers or professional financial advisers for help. Because small investors often do not understand how the market or complicated investments work, they may be vulnerable to outright con artists or to unscrupulous or incompetent investment professionals.

With lump sum retirement benefits and other assets to invest from a lifetime of work and savings, older persons are especially attractive targets for fraudulent and abusive advisers or sales people. While investors of all ages can be seriously harmed by the unethical or illegal practices of unscrupulous financial advisers, older persons tend to be particularly at risk, since they live on fixed incomes and their savings may have to last them for ten or twenty or more years of retirement.

As we will hear from State Securities Administrators today, there are varying degrees of investment fraud and abuse, ranging from outright fraud to incompetence by investment sales persons or financial advisers. Regardless of the motive the effect is the same: to rob senior citizens of their hard-earned savings.

In my own State of Maine, we are not immune from this type of harm. We have, in one instance, a stockbroker who is awaiting sentencing on a fraud conviction in Federal District Court in Portland for setting up a phony trust fund and inducing a number of elderly savers to invest in what he termed safe, high-yielding investments. His retired customers had invested large portions of their life savings into this bogus trust only to lose substantial sums of money.

Of particular concern to me is the case of First Investors, a large mutual fund company which, at one time, had offices in a number of cities throughout Maine, and which is currently being sued by the State of Maine for alleged deceptive sales practices. As we will soon hear from one of our victims today, many older savers and other small investors were allegedly sold mutual funds without regard to their level of understanding or ability to bear risk. Tragically, many of these cases resulted in senior citizens losing thousands of dollars in savings. Let me share a few examples:

In 1991, an 86-year-old husband and his 79-year old wife from Standish, Maine invested $29,000 into one of the First Investor's high yield funds and approximately a year later had lost $10,000 on their investment. They state that they had no idea that the funds invested in junk bonds.

An Ashland, Maine couple, who at one time had been farmers and after a bad crop went to work at a paper mill, invested their lump sum distribution of $18,000 and an I.R.A. of $8,000 into a First Investors fund. They told the sales person that this was the only money they would ever have and must be careful not to lose it. They were allegedly assured that the investment was safe and guaranteed to be better or just as good as a bank. Unfortunately, this was not the case—instead of earning more money—lost about $9,000 of their $26,000 life savings.

A Presque Isle couple in their sixties—he was a heavy equipment operator for a paper company, she was a grocery store clerk—invested $28,500 and were allegedly told during the sales presentation that the investment compared to a bank account, only it had more benefits. They lost several thousands dollars.

Finally, a shop foreman from Dover-Foxcroft and his wife, who worked in a shirt factory, lost $4,600 of their $15,000 after being told by the sales person there was nothing to worry about, that their investment would be protected.

In the State of Maine, approximately 5,000 First Investors accounts were opened with overall losses conservatively estimated in excess of $1 million. As we will hear today, Maine is not alone in challenging First Investors' sales practices. Eight states have brought administrative, civil or criminal actions alleging, among other things, misrepresentation in the sale of these funds, and fifteen states have entered into settlement agreements with First Investors for losses incurred by its investors.

The allegations range from deception in sales pitches to incompetency and inadequacy in the training of sales persons selling the funds. In 1992, First Investors and the SEC entered into a settlement requiring them to pay nearly $25 million into a nationwide restitution fund to be used to satisfy claims of investors and one expert has estimated the alleged nationwide losses in First Investors funds at $400 million. Today we will hear more about this case, as well as other securities-related cases, in which senior citizens have experienced enormous losses.

Mr. Chairman here at the Federal level there is often too much reliance on after-the-fact enforcement as a substitute for regulatory oversight. One only has to look at the Lincoln Savings/American Continental Corporation case to remember that over $250 million worth of unsecured bonds were sold to some 23,000 investors, many of whom were elderly and on fixed incomes. In the cases we are looking at today, there are no federal guarantees for monies lost in these allegedly shoddy investments—senior citizens are just left holding the bag for bad investments.

I am not suggesting that we "overprotect" investors in a way that limits their investment choices or discourages the marketing of legitimate investments. Rather, federal and state regulators and the securities industry itself must do all they can to ensure that investors are fully aware and informed of the risks of investing and to protect them from patently abusive and empty investment promises.

Whether it is boiler-room telemarketers hawking bogus investments over the phone, unethical stockbrokers engaged in unauthorized trading, or incompetent sales persons marketing unsuitable products, the elderly deserve better treatment from financial professionals. It is estimated that the number of Americans aged 50 and older will nearly double over the next quarter of a century. Many will seek the services of financial professionals. These advisors should be required to deliver financial services in good faith, in an honorable fiduciary relationship and with the dignity and respect that their senior citizen customers have earned.

I look forward to hearing the testimony today on what more needs to be done to crack down on fraudulent and abusive investment peddlers and what steps senior citizens can take the protect their hard-earning retirement savings.

## Prepared Statement of Senator Richard Shelby

Mr. Chairman, I commend you for scheduling this hearing today. It goes without saying that all of us are aware of horror stories involving senior citizens who, in their desperate search to supplement their retirement income, have been victimized by con men with fraudulent investment schemes. Unfortunately, even though elderly persons have lost thousands of dollars in fraudulent schemes, many are reluctant to come forth to discuss their experiences because of feelings of shame, embarrassment, and humiliation about their vulnerability. Thus, reported senior citizens' losses in fraudulent investment schemes may be just the tip of the iceberg. Perhaps one of the most cruel ironies of our current efforts toward economic recovery is that while falling interest rates are expected to make more funds available for business investments, elderly persons in search of secure investments will suffer disproportionately because of lower interest rates on bank deposits, CD's and treasury bills.

I hope that this hearing will assist us in getting a more realistic estimate of the magnitude of these problems and will offer some insight on feasible solutions. For example, it may be desirable for employers to provide greater financial planning assistance to their employees before retirement. In addition, this hearing may indicate a need to provide continuing investment assistance after retirement. While such services would increase short-term costs for employers, in the long term, these services should result in substantial savings to society since victimized elderly persons often become wards of the state.

Senior citizens living in large urban areas are not the only targets of fraudulent investment schemes—seniors in rural communities are equally susceptible. In a small, rural community in my state, an insurance salesman ran a fraudulent investment scheme on eight of his clients who were senior citizens. It is my understanding that the insurance agent did all kinds of things to ingratiate himself with these clients. For example, he repaired broken appliances, gave them smoked turkeys for Christmas, stopped by often for dinner, and really just made his clients feel as if he were part of the family.

After gaining the clients' confidence, he would find out if they had any money to put into a bank in Montgomery, Alabama because he told them they would get returns of 10 to 12 percent. Subsequently, the salesman asked his clients to invest in a new company of his, and only gave them a promissory note if he was coerced. He even supplied his clients with lock boxes in their homes to store their promissory notes and insurance policies. Because the clients allowed the insurance salesman to have a key to their lock boxes, those clients who had been given promissory notes subsequently discovered that these notes had been removed.

Finally, the insurance salesman persuaded some of his clients to invest up to $35,000 in high-value life insurance policies. After a few years, the salesman would submit forms for a partial surrender of the policies and use the client's name, but his own address. He would forge the checks when he received them. He also would eventually cancel the policies and get whatever funds were left.

According to the Alabama Securities Commission (ASC), the eight senior citizens involved in this fraudulent scheme lost approximately $500,000. They would have lost more; however, after two of the women hired an attorney, the salesman ceased his fraudulent activities. The ASC says that a report of this investigation is now with the Attorney General and the Commission expects criminal indictments.

My heart goes out to these elderly constituents and to all victims of such schemes. Because seniors have worked hard for years and accumulated significant assets, they are disproportionately targeted by unscrupulous individuals. We must find a way to protect the elderly from investment abuses, so that they may have the quality of life during retirement that they have envisioned. I look forward to hearing from our distinguished panel of witnesses here today to testify on this subject.

### Questions

1. What suggestions do you have, other than education, to help prevent the elderly from investing in these fraudulent schemes?
2. In light of this ongoing problem of investment abuse, do you think that employers should provide more financial planning assistance to their employees both before and after retirement?
3. Is there a need for additional criminal penalties to deter investment fraud against the elderly?
4. Are there any states with cost-effective approaches to these problems which we can use as a model for the rest of the nation?
5. Are the states capable of devising solutions to these problems or is there a need for federal legislation?

PREPARED STATEMENT OF SENATOR LARRY PRESSLER

Mr. PRESSLER. I commend the Chairman for holding today's hearing to address the important issue of retirement security. America's senior citizens must be alerted to the fraudulent investment schemes being pushed by shady investment companies and financial advisors. These con-artists are a threat to senior citizens' livelihood.

Many South Dakota senior citizens have planned carefully for financial stability during their retirement years. Interest and other dividends from their investments are an essential part of their cash flow.

While the low interest rates have many positive effects on our economy, it also has negative connotations. Those who depend on investment income have been hit hard by the drop in interest rates. Many senior citizens have removed their money from Certificates of Deposit (CDs) and other interest-bearing bank accounts, and transferred their savings in more riskier investment options in an attempt to improve their rates of return.

Scam artists and other con-men have talked many trusting senior citizens into investing their money into high risk funds. In many instances, elderly Americans were assured that no risk was involved in their investment.

I have spoken with the South Dakota Attorney General's office. These con artists have not passed over my state. They pass themselves off as investment consultants, long-term insurance brokers and retirement planners. Many of these fraudulent contracts were signed over a cup of coffee at a kitchen table.

An individual who feels he or she has been midlead has several options: He or she can contact the State Attorney General, the Securities and Exchange Commission or file a lawsuit. Despite these avenues of recourse, many senior citizens never recover their financial loss.

Mr. Chairman, there is no easy solution to resolving this problem, but there are some steps we can take. First, we need stiff penalties against the con-artists. Second, we must warn senior citizens to not act hastily when making investment decisions. If something sounds too good to be true—it is. At best, senior citizens should be aware of ways to check out a hot investment tip.

Again, Mr. Chairman, thank you for holding this hearing. We cannot let our seniors' retirement be derailed by fast-talking con-artists. I look forward to listening to today's witnesses to find ways to best protect America's seniors and their hard-earned incomes.

The CHAIRMAN. Senator Craig.

## STATEMENT OF SENATOR LARRY CRAIG

Senator CRAIG. Mr. Chairman and Senator Cohen, let me associate myself with your joint remarks and concur in the importance of this hearing, and I thank you for holding it. There are a lot of reasons why all of us are concerned here in a personal way. Idahoans grow older faster than the national average, because Idahoans seem to want to live longer, and we're awfully happy about that, and a good many retired people are moving into the State of Idaho at this moment, and we're also very pleased about that.

And interestingly enough, one of the schemes that oftentimes they are caught up in for the purpose of expanding their retirement opportunities is the lure of silver and gold, investments in commodities, the very lure that brought the original settlers to Idaho.

I think I would agree with Senator Cohen, maybe there isn't a lot we can do legislatively, but we have mechanisms in place that we ought to be darned sure work well and are constantly out there watching the markets and watching the community that seeks to provide investment opportunity for our senior community. In thinking about this and watching my own parents and other older people who I associate with, Mr. Chairman, I sense that they are one of the last generations that probably did an awful lot of business on a handshake.

And in doing that, they have a great trust that the facts they are given are given in an honest and fair way and that they are believ-

able. It isn't that they are necessarily easy subjects on which certain unscrupulous people can prey, but they come from a generation of people who believed a person's word was his bond, and they operated in those contexts. That gives us even more reason to want to make sure that the agencies we've set up, both at the State and Federal level, to do the proper policing and checking, are functioning.

So oversight hearings, the raising of the visibility of issues like you're offering through this hearing, are extremely valuable as our seniors deal with limited resources in their retirement years and attempt to gain reasonable return from those resources.

With that in mind, I would ask unanimous consent that the balance of my statement be entered into the record.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Craig follows:]

PREPARED STATEMENT OF SENATOR LARRY CRAIG

Mr. Chairman and Senator Cohen, thank you for holding this very important hearing on investment fraud and abuses that can destroy the savings of America's senior citizens.

As you might know, I come from a State whose population is growing older faster than the national average—because Idahoans live a long time and because non-Idahoans find the State a delightful place to retire. Unfortunately, my State is not immune to investment scams. Ironically, those scams often relate to silver or other precious metals or valuable resources—the very things that lured the first settlers to Idaho more than a hundred years ago.

I'm struck by the range of problems we will be exploring today: Everything from outright fraud preying on the elderly, to clearly legal—but inappropriate—investment advice or planning.

Obviously, there isn't a single solution that will prevent all of these different kinds of financial misfortunes from eroding the savings of older Americans. But perhaps the testimony of our witnesses will help us pin down just why seniors are particularly vulnerable to these sorts of problems, so that we can see if there is some legitimate role for Government to play in prevention.

Is it because they weren't prepared for the real costs of retirement and have no real alternatives for supplementing their income? Do our laws need strengthening, or do they need to be more aggressively enforced? Is there no reliable, accessible source of information and counsel for these people? Are they easy marks because they happen to be home a lot and have a lump sum of cash available to invest?

Or is it just because they're members of a generation who did business on a handshake, when a person's word was his bond?

Whatever the reason, I think the fact this hearing is being held will do some good. We can't prevent people from exercising bad judgment—but a public inquiry into this issue may help them recognize the deal that's just too good to be true, or the investment that's just too risky.

I look forward to hearing the testimony of our very well qualified witnesses.

The CHAIRMAN. Senator Kohl.

## STATEMENT OF SENATOR HERB KOHL

Senator KOHL. Thank you very much, Chairman Pryor and Senator Cohen.

As is true about so many of the hearings that this Aging Committee of ours has held, this is a very important hearing. I cannot help but express the opinion that this Committee, that I have served on now since I've been in the Senate for 4 years, has done some extremely important things with regard to people who are getting older in our society and helping them to manage the difficulties that are inherent in a society like ours, where getting

older is oftentimes a problem time, and a time when others prey upon people who are getting older.

The Aging Committee has done a magnificent job in shining the light on the problems of people who get older in our society. As we know, just in the past year, this Committee has done yeoman work, perhaps as much as any other group on the Hill, throughout Washington, in bringing to light the difficulties that elderly people have with respect to pharmaceuticals, the cost of pharmaceuticals, drug prices, how they rise and how people who are elderly and who buy drugs more so than other groups in our society, are bearing the brunt of the unwarranted increase in drug prices in many cases. And we're going to do something about it, and I think it's occuring primarily because of the work that was done in this Committee by Chairman Pryor and others.

So this Committee is really serving the elderly in our society very well. And what we're talking about today are the problems that elderly people have with respect to investments, how unprepared, in a way which is perfectly understandable, how unprepared many of them are to make sophisticated investments at a time when their fixed investments no longer are secure, among other reasons, because interest rates, which have gone down so significantly, no longer provide them with safe havens by way of making investments.

And just shining the light of day on this problem is going to make a difference. Today, as this hearing is being conducted, I wouldn't be surprised if several thousand elderly people across the country will be watching this hearing on C–Span and will be getting a great deal of information on what they can be doing to safeguard their investments to see to it that they don't make foolish investments.

Just having this hearing, shining the light of day, on television, will help thousands of senior citizens across our country. And I fully expect that as a result of this hearing we will be providing additional information to elderly people to help them make smarter investments, safer investments, wiser investments.

So I am pleased to be here. I am pleased to be a part of this Committee, and I feel very much indebted to Senator David Pryor, who has done so much for so long to help people in our society who are less able to protect themselves, to protect their interests, than is true about people who are at different age levels in the United States of America.

So I'm pleased to be here, it's going to be a good hearing, and I'm sure that many good things will come of it. Thank you very much, Mr. Chairman.

[The prepared statement of Senator Kohl follows:]

## PREPARED STATEMENT OF SENATOR HERB KOHL

Thank you Mr. Chairman. Let me begin by commending you for your efforts in this area. You continue to be a leader in protecting older citizens from unscrupulous individuals and unfair businesses practices. I applaud your efforts.

Mr. Chairman, it is a terrible thing to work hard all of your life, sacrifice and save—only to lose the rewards of those efforts to a fast buck artist or sham operation. But that is precisely what is happening to too many of our senior citizens today.

Many of our Nation's elderly depend on their retirement investments to provide a crucial supplement to their fixed incomes. The combination of declining interest rates and economic uncertainty produce an almost desperate desire for seniors living on fixed incomes to find additional protection. What they too often find, however, are rip-off artists who prey on their fears. There are now many people operating who take advantage of seniors and threaten the life they worked so hard to achieve.

When these victims lose their life savings, they lose more than money. They lose confidence, dignity and independence. And when our older citizens lose, we all lose.

Mr. Chairman, it seems to me that there are several things that can be done to address this problem.

First, we must educate older citizens so that they can make sound investment decisions. Lower interest rates have forced many older persons to turn to complicated and risky investments. In many instances, seniors make investment decisions based on incomplete, inaccurate or misleading advice. Often times, senior investors are hoodwinked into risking not some, but all of their life savings. Government and industry must do more to educate and protect this class of investors. Today's hearing is a step in the right direction.

Second, we need to make sure that existing Federal laws in this area are vigorously enforced. We have many statutes on the books that deal with fraud and abuse, but they are meaningless if they are unenforced. Federal law enforcement officials and industry regulators must send a stronger message to the boiler room operators and rouge professionals who prey on the elderly.

Finally, we need to make sure that Federal and State regulators work together. In many instances state regulators are our first line of defense. My state's securities commissioner—Mr. Wesley Ringo—recently advised me that in 1992, his office played a critical role in the recovery of approximately one million dollars in restitutions for Wisconsin investors. This includes money lost by older citizens.

Mr. Chairman, I'm interested in results and results are best achieved by those closest to the situation. It is therefore incumbent upon the Federal Government to make sure that the States have all of the cooperation that they need to get the job done.

Today we will hear from average citizens, investment advisors and State regulators. Mr. Chairman, I look forward to working with you to make sure that we do all that we can to protect our older citizens.

Thank you.

The CHAIRMAN. Thank you very much, Senator Kohl, and thank you for your nice comments, I appreciate those.

Senator Feingold.

## STATEMENT OF SENATOR RUSSELL D. FEINGOLD

Senator FEINGOLD. Thank you, Mr. Chairman.

I would just like to go along with the comments of my senior Senator, Senator Kohl, and applaud the Committee for holding these hearings. I have the freshman's obligation of presiding at 10 o'clock, so I regret that I will miss some of the testimony.

But I certainly agree with Senator Kohl that this Committee has the ability to bring issues to the attention of the American people and, as a result, make things happen. I actually first saw this through Senator Kohl's efforts in Wisconsin, as I've mentioned before, with this Aging Committee. Senator Kohl came to Wisconsin and had this Committee, through his work, talk about abuses in Medicare supplemental insurance.

The mere fact that we had that hearing and the discussions connected with it led to quite a bit of pressure being brought to bear on the insurance industry to get rid of some of the abuses in that area. I think the same thing can and will happen here with regard to the issues you're taking up today.

I think that a lifetime of savings, through the observations I've had, can evaporate just as quickly through these kinds of abuses, through high-risk investments, through fraudulent operation.

Let me also say I am very pleased to be a part of this Committee. You can see that when both Senators from the same State want to serve on a Committee, it's a sign that we are deeply interested in Wisconsin with the concerns of older people. Any attempts to take advantage of them have to be considered, brought out, and addressed, as Senator Kohl has indicated.

I would ask, if I may, Mr. Chairman, that my statement be included in the record and I hope to return before it's over.

The CHAIRMAN. Without objection, your statement will be included in the record.

[The prepared statement of Senator Feingold follows:]

PREPARED STATEMENT OF SENATOR RUSSELL D. FEINGOLD

Mr. Chairman, I applaud the efforts of the Committee, and especially the Chair, in bringing this issue to the attention of both the Senate, and the public. As is so often the case, alerting people to these problems, and particularly educating seniors to both potentially fraudulent operations and legal but inappropriate investment strategies, will go a long way toward stemming them.

A hearing held in Wisconsin by my colleague from Wisconsin and a member of this committee, Senator Kohl, on the problems related to abuses in Medicare supplemental insurance policies—so-called Medigap insurance—helped establish the nature of those abuses, educated seniors on the issue, and laid the groundwork for reforms. As a State Senator, and Chair of the Wisconsin Senate Aging Committee at the time, I can attest that the Kohl hearing was instrumental in our ability to focus public and legislative attention on the problem.

This hearing can, and, I believe, will do the same.

Though the problems of hard core fraudulent practices are serious, we need to be mindful as well of those activities that are more subtle but no less damaging to the savings and retirement plans of seniors. A lifetime of savings can evaporate just as quickly through inappropriate, high risk investment as it can through a fraudulent operation.

I will be interested in hearing what recommendations our witnesses may offer, especially as they relate to educating older consumers about these abuses, encouraging and assisting state regulators in fighting those who would exploit the most vulnerable, and incorporating the existing aging network in any efforts to address this issue.

The CHAIRMAN. Senator Feingold, we will welcome you back when you finish your term of presiding. I think from 10 to 11, is that correct? We appreciate your membership on this Committee, both of you from Wisconsin. You have been very loyal members and we appreciate both of you very much.

Senator COHEN. Senator, I think we have to explain, before Senator Feingold leaves, and Senator Kohl, that for those who are watching, you may have the impression of "Honey, we shrunk the committee," because these chairs are so low up here.

The CHAIRMAN. I have just sent out for some cushions, by the way. I hope they can find us some.

Senator COHEN. They seem to be getting lower and lower, either that, or we're getting older.

The CHAIRMAN. I think they sawed the legs off last night. [Laughter.]

Senator COHEN. We're going to try to sit up tall so we can see all the witnesses who come before us.

The CHAIRMAN. Right.

Let's call our first panel this morning. Minnie Pharr, would you please come forward, and also John Us. We welcome both of you. And I'll tell our audience a little bit about our two witnesses who are going to lead off our hearing this morning.

Minnie Pharr is a citizen of Walls, Mississippi, our neighbor to Arkansas. She and her husband wanted an investment that would provide them income after retirement. They wanted to protect their initial investment. Their broker recommended an investment, explained the generous interest rate they would earn, but not the high risk associated with that investment. The Pharrs lost a portion of their initial investment, and we're going to ask her to basically tell her story.

John Us is a citizen of Fairfield, Connecticut. He invested a lump-sum retirement payment with a broker which was supposed to be used to open a retirement account. The retirement account was never opened and Mr. Us lost his initial investment. In a moment, we'll call on John to explain that to us.

But now we'll call on Minnie Pharr. Thank you for being here today. You may proceed.

## STATEMENT OF MRS. MINNIE PHARR, WALLS, MS

Mrs. PHARR. My name is Minnie Lou Pharr, and I live with my husband, Ezekiel D. Pharr, in Walls, Mississippi. I am 59 years old and my husband is 67 years old. We have lived at this address since 1970. We have two daughters, Rebecca Lynn, who is 33 years old, and Kathryn Lou, who is 35 years old.

I worked as a court reporter in DeSoto County, Mississippi, which is where Walls is located, until I had to retire in 1983 because of heart problems. My husband, Ezekiel, was employed by the U.S. Postal Service in Memphis, Tennessee, as a postal clerk until his retirement on March 31, 1989.

In the mid-1980's, my husband and I realized we were approaching retirement and we became interested in having income after that happened. We had made no other plans for retirement other than a retirement account with the Postal Service. Our only previous experience with investments was limited to bank certificates of deposits.

A friend of ours called us in early 1986 to ask if she could give our name to a man in Memphis that she was using for investments. We said yes. Shortly thereafter, we were contacted by Mark Rutland who said he represented First Investors Corporation, which had an office in Memphis. He asked if he could come to our house, which is not far from Memphis, to talk to us about investing for retirement. We said yes. Mr. Rutland came to our house within the next few days. This was probably in February 1986.

When Mr. Rutland came to our house, my husband and I explained that we were looking for income past my husband's retirement which was coming up in a few years. We explained that we did not want to invest in anything which put our money at risk. Risk to us meant the chance, however slight, of losing our principal investment, which we did not want to do because of approaching retirement. Mr. Rutland recommended that we purchase a bond investment through First Investors Corporation called the First Investors Fund for Income.

He gave us a prospectus and brochures showing that this bond investment was good for all types of financial goals, including ours. He also told us that the bond investment was paying a 12.1 percent return as compared to a 7 to 8 percent return on bank certificates

of deposit. He led us to believe we were not investing in stock but in the bonds themselves, and that they had a fixed rate of interest on which we could rely.

He made it seem like a good, old-fashioned bank account, with which we were comfortable, only with a lot more interest. In fact, Mr. Rutland promised us a fixed interest rate of 12 percent until at least the year 2000. Mr. Rutland's answer to our concerns about the risk of losing our money was that since the investment was in bonds, which would pay a fixed rate of return over a certain period of time, there was no way we could lose.

I asked him specifically about our money being insured, like an account at the bank, which has FDIC protection. He said that although the investment did not have FDIC insurance, it was just as good as if it did. This sounded like exactly what we needed in the coming years, so we felt safe in giving him and his company our money.

We decided to invest while Mr. Rutland was at our house, and we signed the papers for a 10-year investment program in the bond investment. We agreed to transfer about $10,000 from my husband's retirement account into the bond investment and to begin monthly payments of $500. We made other payments along the way.

Much to our surprise and dismay, the value of our investments declined significantly very quickly. It was not until this began happening that we came to understand that our principal investment money was at risk, apparently at a very high risk. We found out that we were not investing directly in the bonds as we had been led to believe, but that we had purchased shares in a company called First Investors Fund For Income, Inc., which invested in the bonds. These shares in the company could go up or down in value, which meant that our money was at risk all along.

We learned this from our monthly statements, not from Mr. Rutland or from anyone else from First Investors Corporation. Mr. Rutland did contact us during the first few months of our investment, but it was mainly to ask about more investments with him. I understand that Mr. Rutland left First Investors Corporation shortly after we invested.

We should have been told by Mr. Rutland before we invested that our money was not safe from possible loss and that we were not buying the bonds directly. We also were not aware of the high fees and commissions which would come out of our money. We were never contacted by anyone from First Investors Corporation and asked if we were satisfied with our investment or if we had any questions about it. We stopped making the monthly payments in late 1987 after we became concerned about the safety of our investment.

My husband and I have not been able to determine exactly what our loss is, but as far as we are concerned, for the purpose we invested, it is a total loss. The Securities Division of the Office of Mississippi Secretary of State Dick Molpus tells me that according to the records they have, which are incomplete, as of the end of December 1991, we had given First Investors Corporation about $24,000. Based upon their estimated calculations using a more con-

servative 8 percent return, not the 12 percent that we were promised, we had lost about $9,000 at that point.

When my husband retired, we took a lump-sum retirement amount of $30,000. We had hoped to also invest that money for our retirement years, but we were forced to use it for home repairs and living expenses, because the income we had counted on first First Investors Corporation investments did not happen. All of the $30,000 is now gone. We left about $10,000 in First Investors Fund for Income because we were told that it must stay there because of pending lawsuits against First Investors Corporation. We took about $16,000 out a while back and invested it elsewhere.

Needless to say, this has been a very traumatic experience for me and my husband. We are now in serious financial trouble in our retirement years, when we should be enjoying the rest of our lives. We are going to have to sell our home in which we have lived for 23 years because the retirement income we will still receive from the Postal Service is not enough for us to keep it. The emotional stress from the problems we have had with First Investors Corporation has been very difficult to deal with, particularly at our age.

We can only ask that you carefully consider our statement and any other testimony or information before you. It is our hope that you will then take whatever steps are needed to protect unsophisticated persons such as ourselves from such unscrupulous and deceptive sales practices. It is too late for us, but perhaps others can be protected as a result of our example.

The CHAIRMAN. Mrs. Pharr, thank you very much for your statement. We will have some questions in a moment.

I will call on Mr. Us at this time. And right after Mr. Us makes his statement, I'm going to call on our friend Senator Grassley from Iowa.

Mr. Us.

## STATEMENT OF JOHN US, FAIRFIELD, CT

Mr. US. Thank you, Mr. Chairman.

My name is John Us. Mr. Chairman and members of the Committee, I appreciate the opportunity to appear before you today to tell you how I lost $50,000 of my life savings in what appears to be an investment scam. Of the amount I lost, $45,000 was from a lump-sum profit-sharing retirement distribution I received when I left my job. I am now 62 years old and I have had to go back to work as a toolmaker because I lost all my money I had planned to use for my retirement years.

Here is how it happened. Three years ago, while at a dance studio I belong to, I met Tom Holeva, who told me he was a securities broker. A day or two after meeting him, Mr. Holeva called me at work saying that he had a great investment opportunity for me. He told me that for a $5,000 investment in Franklin Coins, I would receive a return of 12½ percent monthly dividend and that by the end of 1994 I would receive back in full my initial $5,000 investment after selling my position.

The only catch was that he needed my funds within 24 hours or the price would go up. I went that afternoon to the bank, withdrew the funds, and turned the money over the next day to Tom Holeva.

It now is 3 years later and all I have received is one check for about $212. There is no more money left in the account.

I grew to trust Mr. Holeva and one day I mentioned to him that I was about to receive a profit-sharing check from my previous employer. He suggested that I put the money in a tax-deferred retirement account. At a meeting my son and I had with Mr. Holeva to discuss my situation, I stressed that the money should be put in qualified plans so that I would not have to pay taxes until my retirement. Mr. Holeva gave me a few options, from which I chose a no-risk, safe government fund. On March 10, 1991, I gave Mr. Holeva a check for $45,000, which represented the payout from my profit-sharing plan.

Mr. Holeva immediately began buying and selling all kinds of stocks. I never really understood my account statements. When I contacted Mr. Holeva by phone to inquire about the status of my account, he usually gave me ambiguous answers. He also said that he had a certain amount of time to use the money before he had to set up the IRA account. Mr. Holeva continued to buy and sell stocks, making big commissions for himself. When I asked him about it, he said that he was trying to build up the account so that he would have more money to put in my retirement plan.

In July 1991, I instructed Mr. Holeva to stop buying and selling stock after I lost a large amount of money on one of the purchases he made for me. I had to tell him to stop trading in my account, even though I had never authorized him to buy any of the stock at all.

Mr. Holeva said that if I would just give him a chance he was confident he could get my money back up to the amount of my original investment, and maybe more if I would just be patient. Naturally, I agreed, since the majority of my money already was gone at this point anyway. I continued to trust Mr. Holeva, although I was beginning to get a bit suspicious.

A short while later, Mr. Holeva started buying a lot of one particular penny stock. The value of the stock would go up and down, and up and down again. I was starting to get worried, but Mr. Holeva assured me that everything was okay and that I should hang on to the stock. When I would call him he would send me a press report about the stock and about how the Israeli government had a $50 million contract to purchase the product and so on. Five months later, in late December, I tried to contact Mr. Holeva to get together to discuss my financial situation. He would schedule meetings and then not show up. On the few occasions we did meet, he wouldn't give me any straight answer.

Finally I got together with Mr. Holeva at the home of another concerned investor. At that meeting, in late January, Mr. Holeva said that he had good news, my account had grown to $100,000 due to the success of the penny stock he had purchased for me. He also told me at this time that he was changing jobs and joining another brokerage firm. He said it was a better company to deal with and that my monthly statement would be easier to understand. He assured me that the transition of my account from one company to another would be smooth and swift.

Unfortunately, that turned out not to be the case. It took months to transfer all the stocks, and then many of my shares were miss-

ing. When I asked Mr. Holeva about this, he evaded my questions. Also he ignored my many requests that I be given physical possession of the actual stock certificates.

At that meeting, I instructed Mr. Holeva once again not to trade in my account without my permission, and I told him to sell all the entire position of my penny stock. The next day, he allegedly went to sell my shares of the penny stock, just as the bottom fell out and its value plunged to almost nothing. When I talked to Mr. Holeva the next day, he told me everything was fine because he put the sell order in at 9 a.m. and the stock did not dive until after noon.

I soon learned that was not the case. As it turns out, the sell order never was executed. Mr. Holeva suggested that we register a complaint with someone at the brokerage firm where he previously had worked. He told me that I had a good chance of recovering the money that I lost and that he was working on something and I was not to mention this to anyone.

Some time went by, and Mr. Holeva said the penny stock shares I still held were starting to creep back up, enough so that I could open up an IRA account with about $30,000 in it. In March of last year, Mr. Holeva came to see me so I could fill out the paperwork to open up an IRA, in which he would put approximately $30,000. He indicated he would try to bring my balance up to my original investment by playing with the few shares of the stocks I had left.

I learned in March of this year that Mr. Holeva never ever opened an IRA account for me. Ironically, this meeting was called by Mr. Holeva's bosses to inform me that he mistakenly put 18,000 shares of Franklin Mint stock in my account and they had planned to hold me responsible for that money, despite the fact that Mr. Holeva lost all of my money. It was at this meeting that I learned that Mr. Holeva had lost the entire amount of my money I had turned over to him and that two of my three accounts had negative balances. In addition to losing all of my retirement money, my tax status is in jeopardy because I never put these funds in an IRA account.

I have learned the hard way that Mr. Holeva was lying to me all along. It hurts to lose your life savings in such a way. Mr. Holeva should be prosecuted for this. I am not the only one he has done this to. I know of four other people with similar stories. He should be behind bars and the companies he worked for investigated so that other innocent people do not get robbed like we did. He should never be allowed to deal securities again. He is a fake, a fraud, and a phony.

Thank you for listening.

The CHAIRMAN. Thank you, Mr. Us. We appreciate your statement. We're going to have some questions in a moment.

We have another arrival here, Senator Simpson. But let me if I could call first on Senator Grassley, he's been waiting patiently.

## STATEMENT OF SENATOR CHARLES GRASSLEY

Senator GRASSLEY. Mr. Chairman, how would it be if I make a deal with you, if I put my statement in the record——

The CHAIRMAN. Perfect, I'll accept that deal.

Senator GRASSLEY. I could ask a couple of questions right now and then go to Judiciary?

The CHAIRMAN. Yes, that would be fine. We'll put your statement in the record.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Mr. Chairman, I'm glad you are holding this hearing.

I think the attention it will give to the problem of investment fraud will make many older people more careful of how they invest their money. If we can develop a legislative initiative on the basis of the hearing so much the better.

As a number of our witnesses will point out in their testimony, many older retired people are under considerable pressure to earn more from their savings.

Although the plunge in interest rates, and the continuing low levels of those rates, *have been a boon for many in our society,* they have not helped retired older people who look to the earnings from their savings to maintain a comfortable standard of living.

People in this situation, with limited opportunities to earn money through work, will often be eager, and maybe even desperate, to find ways to make their savings earn more. Under those circumstances, they may be more vulnerable to the appeals of those who may want to profit off their savings and their need.

I want to hasten to add, Mr. Chairman, that older people are not the only ones who can be vulnerable to the kinds of schemes we are going to hear about today. *Younger people may also be defrauded of savings.*

And although some older people may be more vulnerable because they have a substantial lump sum pension payout, and may have very limited experience in investing, others may well have a fair amount of experience at it.

So I think that your hearing can help not only older people, but can help anyone who has a sum of money that they are considering investing.

With that I'm finished Mr. Chairman. I look forward to hearing the testimony, and I will have a few questions.

The CHAIRMAN. How does that square with Senator Cohen, our vice-chairman?

Senator COHEN. Well, Mr. Chairman, let me say that Senator Grassley and I both serve on the Judiciary Committee. Last week, I tried to have them adopt a rule of early bird, the first one to arrive would get to ask questions, and then Senator Grassley raised such a fuss about that, I have now been relegated to the very end of the questioning sequence in the Judiciary Committee. So I guess it doesn't matter whether he gets there first now or not. So I have no objection to him going first.

Senator GRASSLEY. Thank you.

First of all, the stories you just told I'm sure can be repeated by a lot of people in America, and probably not just by retired people either, or people who are near retirement. In either case, obviously we have to be very sorry to hear about the difficulties that you and others encounter, and which you have described for the Committee today. And I'm sure you're here and I'm sure Senator Pryor is holding the hearing, because if there is anything this Committee can do about it, to avoid this sort of distressing experience, we should try to do it.

Mr. Us, let me ask you whether you tried to get information about Mr. Holeva when you began to get concerned about what he was doing with your money, and if so, how did you go about trying to get information?

Mr. US. Initially, I was just talking to some of my friends who were dealing with him also. I just talked to some of the people who had money invested in the same company. I never really got in contact with his boss, because every time I would call him, I would call the place and he was either not there or nobody was there to an-

swer the questions. So this was going on and on and on. Months went by and I always heard the same type of answer, I never really got any information from anyone.

Senator GRASSLEY. I assume, though, there was something about the individual you had at least at the beginning some sort of confidence in him, right?

Mr. US. I had trust in him. I'm just that type of person, I like to trust people. And I knew the person, and I didn't think it was possible somebody could do something like this.

Senator GRASSLEY. Whatever happened to Mr. Holeva? Was he ever caught and brought to justice, so far as you know?

Mr. US. Not as far as I know.

Senator GRASSLEY. Mrs. Pharr, I gather from your statements that you learned fairly quickly that the investment was declining in value. I think you referred to this in your statement. Is that the case, and do you know exactly how much you lost?

Mrs. PHARR. Not exactly.

Senator GRASSLEY. You don't know exactly?

Mrs. PHARR. No. I could possibly figure that up and give it to you later.

Senator GRASSLEY. Did you try to learn about the safety of your investments or about the person you were dealing with?

Mrs. PHARR. The person who recommended him was a very reliable friend whom I had known for many years. And she had invested much more money in the company than we had. And I felt confident, since it was insured by "an insurance company as competent as FDIC" that it would be safe.

Senator GRASSLEY. Did your friend likewise lose money, the person that advised you to go to this company?

Mrs. PHARR. I wish we had done what she did. But when Mr. Rutland, the salesperson, left First Investors, she moved her account with him to another company. So she to my knowledge did not lose anything.

Senator GRASSLEY. You said you were going to try to determine what the loss was, so maybe that answers this question. But to this point, is there any reason that you have not been able to determine the exact amount of money you lost?

Mrs. PHARR. I think the mistake——

Senator GRASSLEY. Or is it the case that you haven't sat down to actually figure it out? Is there some reason in your dealing with the company that you weren't able to get the information you should be entitled to?

Mrs. PHARR. No, I think in the statement it was about $9,000 now.

Senator GRASSLEY. That's okay for now. What about your experience with the Securities Division? And it's my understanding that's under the authority of the Mississippi Secretary of State's office. Were they helpful to you?

Mrs. PHARR. Very much so, yes. One of the attorneys with the State Attorney General's Office came to our house twice and talked to us at length about this.

Senator GRASSLEY. Okay.

Mr. Chairman, I yield, And I'll put my statement in the record.

The CHAIRMAN. Yes, your statement will appear in the record.

Senator Simpson, did you have a comment?

## STATEMENT OF SENATOR ALAN K. SIMPSON

Senator SIMPSON. Mr. Chairman, I came by to commend you and Senator Cohen. I admire so much both of you. We all came here together in 1978 and I know you both so well. It is very pleasant to see the way you work together. And again, this is a very important thing. As I say, I have practiced law in a very small community and I have seen these things happen.

Then with three living parents, my wife and I have her mother at 92, my mother 92 and my father 95, my mother always had a philosophy about this. She had some Texaco stock she got when she was 15 from her father, 100 shares, it was always in her own name. She never changed it. My father would say "Now, let's just put this in joint names, that's what these people are advising." And she said "No, I'm never going to put it in anybody's name but mine."

So control is important, and we can't protect people from human issues, but we can certainly protect them from institutions that would prey on them. And I thank you both, and I will submit my questions in writing.

[The prepared statement of Senator Simpson follows:]

### PREPARED STATEMENT OF ALAN K. SIMPSON

I want to commend Senators Pryor and Cohen for bringing this important and timely issue of investment fraud before the Aging Committee this morning. In today's tough investment climate in which investors are confronted with low-interest rates, seniors are particularly hit because most of them are living on fixed incomes from pensions and Social Security. Living off of a nest egg becomes increasingly more difficult in these times of low-interest rates.

Naturally, people on fixed incomes will try to make the most of their investment income, and seniors unfortunately become victims of investment abuses within the financial investment system more than other investors. Seniors often begin to have total dependence on those whom they choose to trust for investment advice. There have been many examples of blatant and deliberate investment fraud on the elderly, and most of the time it is persons who the seniors consider friends and trust the most who are taking the most advantage from them. We will hear of two such heartbreaking cases today.

Unfortunately, most of the incidents of fraud abuse involve elderly of modest means. These individuals tend to have the least sophistication and thus the greatest dependence on others for advice. More importantly, they are the ones most financially hurt by such abuses because they cannot afford to lose their savings and cannot simply write their losses off as a lesson learned for the future.

This type of fraud is the worst kind—preying on persons who depend on you the most for credible and reliable advice. We must focus our attentions on raising public awareness of the victimization of the elderly in the investment marketplace. In addition, educating older Americans on how to avoid being the next victim in an investment scam should be a priority objective for this committee and the investment community.

I look forward to hearing from today's witnesses and once again thank Senators Pryor and Cohen for bringing this important issue to the Aging Committee's attention.

### QUESTIONS

State securities administrators:

1. What types of investment abuses do you see the most?
2. Why are the elderly such obvious targets for these types of abuses?
3. What can be done to prevent these investment abuses from occurring?
4. Does the securities industry need more oversight from the Government? Are we enforcing the current laws enough or do we need to place more emphasis on enforcement?

Financial planning experts:

1. What can be done to educate the elderly about these fraudulent practices and fraudulent investment planners?

2. How can these abuses be prevented?

The CHAIRMAN. Thank you, Senator Simpson. Thank you for your nice comments.

I'll go forward with a few questions, then I will yield to my colleague, Senator Cohen. Did you ask, Mrs. Pharr, did you ask Mr. Rutland to put into writing any of the promises? For example, I think Mr. Rutland said that he was going to guarantee that this was going to pay you 12 percent or in that range of interest? Did you ask him to put that in writing?

Mrs. PHARR. I don't recall exactly if we did. But I remember following up with a phone call the next day asking him, and he reassured me that it would be at 12.1 percent interest until the year 2000, that I was locked in and that there was no way we could lose.

The CHAIRMAN. Did you ask him to show you any kind of a license or anything? Was he a licensed financial advisor or was he a securities dealer? Did he have a license that you knew of?

Mrs. PHARR. I think he had some documentation of his qualifications.

The CHAIRMAN. I see. And when he moved from the company that you had invested in originally with him to another company, you thought that your investment was being moved to the new company, is that correct?

Mrs. PHARR. No, sir.

The CHAIRMAN. What was the situation at that time?

Mrs. PHARR. We weren't aware that he had left First Investors until quite some time afterwards.

The CHAIRMAN. Now, were you being given any kind of a statement on a monthly basis from his company? It was word of mouth from Mr. Rutland, was that correct?

Mrs. PHARR. Yes.

The CHAIRMAN. Did you ever ask him for a statement of your account?

Mrs. PHARR. Well, the company sent monthly statements, so we just took those.

The CHAIRMAN. The company did send you monthly statements?

Mrs. PHARR. Right.

The CHAIRMAN. And you were watching your investment?

Mrs. PHARR. Very closely.

The CHAIRMAN. Very closely. And was it going up or down at that time?

Mrs. PHARR. Down.

The CHAIRMAN. It was going down. Did it ever go up?

Mrs. PHARR. Well, I understand now it is gradually going up.

The CHAIRMAN. But you are still in a loss situation?

Mrs. PHARR. Yes.

The CHAIRMAN. Did you report Mr. Rutland to the Mississippi Secretary of State.

Mrs. PHARR. No, I did not. Someone else did.

The CHAIRMAN. Someone else did. But they did come to see you in your home and discuss this fellow with you?

Mrs. PHARR. Mr. Mike Henry, an attorney with the Mississippi State Attorney General's Office, is the one that contacted us when he heard about the litigation in other States.

The CHAIRMAN. What is his present situation? Has he been prosecuted? Has he been charged with any wrongdoing? Was he breaking the law?

Mrs. PHARR. Mr. Rutland?

The CHAIRMAN. Yes.

Mrs. PHARR. In all honesty, I don't think the man realized that he was breaking the law, and to my knowledge he was not prosecuted. He was just repeating what he was told to say from the company.

The CHAIRMAN. From the company that he worked for?

Mrs. PHARR. Right.

The CHAIRMAN. Did you know the amount of commissions or fees that he was being paid when you would invest your money with him?

Mrs. PHARR. We asked him, and he told us, but we did not realize that they were going to get their portion off the top, on the front end, which they did, which is something that made us quite angry, really.

The CHAIRMAN. Do you know the amount of fees that he earned from you and Mr. Pharr?

Mrs. PHARR. No, sir, I do not.

The CHAIRMAN. Do you know the percentage that he charged?

Mrs. PHARR. The percentage was in the prospectus, but we kind of had to dig all this out ourselves. I do not know the commission Mr. Rutland made on the sale.

The CHAIRMAN. I see. I'm going to yield to my friend, Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman.

Mr. Us, let me just turn to you first. Was the individual, Mr. Holeva, at the same dance studio?

Mr. US. Yes, he was there for a while, not that long, but that's where I met him.

Senator COHEN. Long enough to waltz you around?

Mr. US. Right. He usually brought with him the briefcase with different stocks, options, and he would show to the people.

Senator COHEN. So I take it then he joined this dance club and kind of came in and then got your money and waltzed right out?

Mr. US. It is possible that was one of the ways to meet people.

Senator COHEN. Did the people who belong to the dance club tend to be of your age or older?

Mr. US. Some were my age and some younger. I know a couple of other people who were also involved with him, they met him the same way I did, through the studio.

Senator COHEN. Let me say that naivete is not reserved just for those at the older end of the spectrum, it also applies to those at the other end. I'll give you an example. When the broker said to you he had to have $5,000 within 24 hours or the stock was going to go up, it reminded me, as I was sitting here listening, to my days in my first year in law school.

My wife and I at that time had just had a baby, our first son. A visit was paid by a salesman for—I'll skip the name of the com-

pany right now. But obviously he had targeted us, we were living in a hovel at that time, I must tell you it was pretty bad. It had a bathroom on the other side of the hall with a pull chain. We were living on $8 a week for food for the three of us at that time.

This salesman came and he said "Have I got a deal for you. I've got this terrific crib. It will not only take care of your baby now sleeping in your bed, but as that baby gets older, you can continue to extend the crib. It becomes a single bed, buy another mattress, maybe even make it into a double bed, and by the time you get through it will be a king size, I think. And you can even use it in your retirement home."

And in addition to that, you would get free pictures of your son for the first 6 years of his life. And it went on and on in this fashion. And I said "Sounds terrific, can I have overnight to think about it?" The answer was no, right now or the deal is off. So being a young 6 months into law school, I thought I was pretty sophisticated at that time, I bought the bed.

It's still in the attic. But you can see the kind of pressure tactics that many people are vulnerable to. It's not just the elderly or those in retirement, but the young as well. Senator Simpson just suggested, there's an Old Latin phrase about caveat emptor. We've got to be very careful when we buy anything these days, particularly when you're dealing with something called investments.

The difficulty, of course, is that you rely upon certain individuals, either through a personal friendship that you develop because you shared perhaps a dancing interest at that time, or through someone that you know, who recommends this particular individual, like Mrs. Pharr, where apparently a friend had recommended Mr. Rutland to her. So you can rely on friendships in dealing with a certain individual, and then representations are made. Then the line becomes somewhat thin as to what is a false representation or something which is close to misrepresentation or to what simply is high pressure sales techniques. And this is not something, necessarily that we can legislate here from on high in Capitol Hill.

So we have to have to try to determine what can be done. What can be done to protect other innocent or as you have phrased yourselves, less sophisticated or unsophisticated individuals. I'm not sure who is sophisticated when it comes to investments. I believe, Mrs. Pharr, if I'm correct, you had only invested in CDs until that time.

Mrs. PHARR. Yes.

Senator COHEN. And Mr. Us, had you invested in anything at that point?

Mr. US. I wanted money to go strictly into a retirement plan, an IRA account, and I understood that he could still buy and sell stocks if the money is in an IRA. That's the way he led me to believe.

Senator COHEN. Did you ever get suspicious?

Mr. US. Yes, I did.

Senator COHEN. Well, let me stop for a second. You gave him $5,000, right, the first time?

Mr. US. Right.

Senator COHEN. You never got a return on that $5,000?

Mr. US. Just one. And after that——

Senator COHEN. But you didn't get the return before he then asked you for $45,000, did you?

Mr. US. Right.

Senator COHEN. So you gave him $5,000, you got no return at that time, and he said "How about that retirement check you've got for $45,000" you told him about. Did you not at least get suspicious that you didn't get any return on the $5,000 before you gave him another $45,000?

Mr. US. I did. I asked him why I wasn't receiving any dividends. He told me that it was going into a general fund, accumulation. That's the answer I got from him.

Senator COHEN. Did you know whether or not he was acting on behalf of himself or a brokerage firm at that time?

Mr. US. The way—I'm not familiar with stocks and stock markets. I just thought he was under supervision, working for a company, that everything was legitimate.

Senator COHEN. In other words, you didn't do any checking on your own in terms of whether he was working for somebody else?

Mr. US. No, right.

Senator COHEN. Whether he was selling on his own, whether he was with a legitimate brokerage firm?

Mr. US. I did check.

Senator COHEN. What his record was?

Mr. US. I did check to see if the brokerage firm was legitimate, and it was legitimate, but not a very large brokerage, small.

Senator COHEN. What's the total amount that you have received from your investment of $50,000? What have you received in return for placing $50,000 with this individual?

Mr. US. Actually, just the $212. That's it.

Senator COHEN. You got $212 back?

Mr. US. Yes. The whole thing, the whole stock went down to zero.

Senator COHEN. And you've gone back to work now?

Mr. US. Yes.

Senator COHEN. Because you have no retirement benefits left at all.

Mr. US. Well, Social Security.

Senator COHEN. Social Security. All right.

Mr. US. I have some small amount in the bank also under IRA.

Senator COHEN. Mrs. Pharr, were you aware that the investments that were going to be made with your money were going to be invested in so-called junk bonds?

Mrs. PHARR. Heavens, no. We would never have invested in junk bonds.

Senator COHEN. Were you aware that the First Investors Fund For Income, I guess they call it FIFI, did you know that they invested in those funds with your money?

Mrs. PHARR. We did not.

Senator COHEN. If you had known that the Fund consisted mostly of junk bonds, would you have invested?

Mrs. PHARR. I wouldn't have touched it with a 10-foot pole.

Senator COHEN. Did you understand the prospectus that you read?

Mrs. PHARR. No.

Senator COHEN. You didn't understand it?

Mrs. PHARR. Not all of it, no.

Senator COHEN. When you didn't understand it, did you call upon anybody to help you understand it. Did anyone explain it to you?

Mrs. PHARR. No, I guess I just had faith that more people live by the Golden Rule than they do.

Senator COHEN. Now, the friend that recommended this individual to you, did that friend also have money invested with this individual?

Mrs. PHARR. Yes.

Senator COHEN. Did that friend lose money as well?

Mrs. PHARR. I don't believe so, I'm not sure. But as soon as the salesperson resigned from First Investors Corporation and went with another company, she transferred all of her funds out of First Investors into his new company.

Senator COHEN. She is still your friend?

Mrs. PHARR. Very much so, yes.

Senator COHEN. One thing that struck me, you said that the salesperson, Mr. Rutland, told you that even though the investment didn't have FDIC insurance, it was just as good, right?

Mrs. PHARR. Yes.

Senator COHEN. What did you think he meant by that?

Mrs. PHARR. I felt nervous about it, and I don't know exactly what he meant except that it had the security, the same as FDIC.

Senator COHEN. Did any alarm bells go off in your head, when someone tells you this is good as gold, do you want to put the coin in your mouth and see if it bends or not?

Mrs. PHARR. A yellow light came on, yes.

Senator COHEN. A yellow light?

Mrs. PHARR. Caution.

Senator COHEN. Caution, but you weren't cautious.

Mrs. PHARR. Not enough, evidently.

Senator COHEN. Do you have any idea what you expect to recover from First Investors?

Mrs. PHARR. I would like to think it would be all that we have invested, but I have a little bit of doubt.

Senator COHEN. Do you have any idea how many other people in Mississippi have situations like yours?

Mrs. PHARR. Many.

Senator COHEN. Many?

Mrs. PHARR. Yes.

Senator COHEN. Both of you can look at this chart that we have here, that Senator Pryor and I have put on the stand over there; sort of the seven commandments. Do you have anything you would either want to disagree with or add to those seven commandments as far as people who are watching or listening to this hearing, as to what they should do when someone comes knocking at the door, or at a dance hall, or at a friend's home? What lights like this red one here should go on?

After all, there are legitimate investments to be made, there are legitimate brokerage firms, there are legitimate salespersons and brokers. And so we don't want to discourage people from investing

their money as such. But would you add to or subtract anything from that list you see over there on the board?

# Safe Investing

- Don't Buy Investments Over the Phone
- Demand a Prospectus
- Do Homework
- Check Broker's Record
- Define Your Own Investment Objectives
- Don't Give Control
- Read Statements

## SAFE INVESTING

- DON'T BUY INVESTMENTS OVER THE PHONE
- DEMAND A PROSPECTUS
- DO HOMEWORK

  [Read the prospectus; if you don't understand have someone else read it before you give money]
- CHECK BROKER'S RECORD

  [Call the National Association of Securities Dealers or call the North American Securities Administrators Association at 202-737-0900 who can refer you to the State official in your home State]
- DEFINE YOUR OWN INVESTMENT OBJECTIVES

  [i.e., low risk; steady income; get the broker to sign a statement agreeing with you on these objectives]
- DON'T GIVE CONTROL

  [Don't give the broker complete control -- never sign a paper that gives the broker the right to buy and sell without your approval]
- READ STATEMENTS

  [Call your broker if you do not understand the statement]

Mrs. PHARR. I would say understand the prospectus, know what the money is on the front end that is the commission of the company or the salesperson, understand what you're doing more than we did.

Senator COHEN. How about you, Mr. Us?

Mr. US. I would add that people should be very careful when somebody approaches them, they should call in and find out if that person is working for a legitimate company and investigate before going into something like we did.

Senator COHEN. How about the old rule, when something sounds too good to be true, it usually is? Should that be a general rule for people who——

Mr. US. More than often, something is not as good as it looks.

Senator COHEN. When they tell you a guaranteed return of 12 percent——

Mr. US. Right.

Senator COHEN [continuing]. Does that raise some alarm bells? Do you say how can you guarantee 12 percent when the going rate of CDs is 6 or 5 or 7?

Mr. US. It sounds good, but it's tempting, and that's why people go for it, I guess.

Senator COHEN. Okay. That's all I have, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Cohen.

Mr. Holeva, you say that he has not been prosecuted or charged with anything, to the best of your knowledge?

Mr. US. Not to my knowledge, no.

The CHAIRMAN. Do you know of other people who have done business with this individual?

Mr. US. Yes.

The CHAIRMAN. And what has been their situation?

Mr. US. They also lost money.

The CHAIRMAN. They lost money?

Mr. US. But all the people that I know, there are about five of them, they lost money with him, but in a different way than I did. They invested money, where I had my profitsharing, which was my retirement plan, all I wanted to do was roll it over to keep it in a retirement plan in my name. But other people just invested, one person I know lost $30,000, another lost around $40,000, and another lady I know, she lost $5,000. They all lost money with him.

The CHAIRMAN. Mr. Us, did you have any understanding of the amount of commission or fees that this gentleman was earning?

Mr. US. I don't know what it was like, it seemed like it was pretty high, it could be like 15 percent or something, some of the commission he made.

The CHAIRMAN. But you don't know exactly how much commission or fee he made from you?

Mr. US. I don't have those exact figures, no.

The CHAIRMAN. Did the other people who also lost in their investments with this individual report him to the proper authorities in the State of Connecticut?

Mr. US. I don't know if they reported it. But two people have an attorney, hired an attorney to investigate. And I was the only one who reported to the Commission, the Stock Exchange Commission.

The CHAIRMAN. What was the result after they had hired the attorney? Do you know?

Mr. US. It's still ongoing.

The CHAIRMAN. Still ongoing. How long was your relationship with this individual?

Mr. US. Probably around—I knew him around 4 years maybe.

The CHAIRMAN. Four years?

Mr. US. About 4 or 5 years.

The CHAIRMAN. When he called you on the telephone at your work, you knew him?

Mr. US. I knew him then, yes.

The CHAIRMAN. You had known him previously.

Mr. US. So I kind of trusted him.

The CHAIRMAN. I see. And so how long was your investment relationship with him, when you were making investments with him?

Mr. US. Three years.

The CHAIRMAN. Three years?

Mr. US. Yes.

The CHAIRMAN. I want to thank both of our witnesses today, and we very much appreciate your coming. You have come a long way, and we hope that the stories that you have told us today are going to warn your fellow Americans about some of the pitfalls of investing when you're not certain, and maybe not quite as understanding as you should, and we really appreciate your sharing your stories with us. Thank you very much.

Senator Cohen and I are going to take those stories and try to see what we can do to help people just like you in the future to maybe have a little better understanding and a little better appreciation for some of the safeguards that might be taken. Thank you very, very much.

We're going to call our second panel at this time. Our second panel consists of Mr. G.W. "Bill" McDonald, Mr. Steve Diamond, and Mr. Barry Guthary. Let me give you just a paragraph on each of them as they take their seats.

Mr. McDonald is Assistant Commissioner in charge of the Enforcement Division of the California Department of Corporations. He's also active in the North American Securities Administrators Association. He serves as the Chair of the Enforcement Policy Committee.

Mr. Diamond is the Maine Securities Administrator, from Senator Cohen's State. In this capacity, he manages the agency's efforts with respect to the registration of securities offerings, the licensing of securities professionals and enforcement of the Maine securities rules and regulations.

Mr. Guthary is the Director of the Division of Securities for the Massachusetts Secretary of State. He also serves as President of the North American Securities Administrators Association.

And we appreciate very much the three of you appearing today. Let me state, because our previous panel took a little more time than we had anticipated, we're going to use the 5-minute rule. We will put all of the total statement that you give into the record, it will be made a part of the record, but we would appreciate it if you could, limit your statements to 5 minutes and then we will follow with questions. I think we will call on Mr. McDonald first.

**STATEMENT OF G.W. McDONALD, CHAIR, ENFORCEMENT POLICY COMMITTEE, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; ASSISTANT COMMISSIONER, ENFORCEMENT DIVISION, CALIFORNIA DEPARTMENT OF CORPORATIONS**

Mr. McDONALD. Thank you, Mr. Chairman. Good morning, Senator Cohen.

Mr. Chairman, it's a pleasure to be here this morning to talk about this important issue. The States identified an issue several years ago which we called affinity group fraud. And that is fraud which targets particular ethnic or religious or other cohesive groups with a sense of community and a common bond. In California we have seen it in the Hispanic community, the Asian community, the African-American, fundamentalist Christian, Mormon, Jewish, airline pilots, police officers. Today we've heard about dance hall attendees, and the elderly cutting across this group.

What is common to affinity group fraud is a sense of community within a group, and then a con artist who uses that sense of community against the group. This is a complicated world that we live in, and one of the ways that people use to determine who to do business with is people who are like themselves. And what they tend to do is they tend to substitute their faith in the group for their normal business judgment.

So it's a very common occurrence in California to see someone work their way into a group by recruiting opinion leaders, doing favors, paying finders fees, appealing to the special concerns and special fears of that group, targeting advertising in media appeals, offering high return, no-risk types of investments. And it plays on the big lie, this is our chance to get a piece of the American dream, and it's just for us, it's just for our community.

So there is a sense of empowerment which goes into the hopes and dreams of people who become involved in the scheme. And ultimately there is an abuse of trust, ultimately people lose their money, they lose their faith in the group, and it shakes their most basic support system. So affinity group fraud is a very serious problem in this country, and fraud on the elderly is particularly pernicious. If I were conducting a school for scoundrels, lesson number one would be to target the elderly. Because they are a particularly susceptible group. And I would give seven reasons why the elderly are particularly vulnerable.

First, they have a nest egg. Why bother with the young couple with $8 a week to spend on food, when you can go for an elderly couple which may have $50,000 or $100,000 or more in the bank? Second, they are on fixed incomes, and the fear that they have is that they are going to run out of money before they run out of life.

So the mantra that you use to make the investment sound attractive is, it's guaranteed, it can't miss, it's a high return, it's no risk. The truth of your statement doesn't make any difference. You just keep saying it over and over and over again, and people want to believe it, because they're earning 5 percent at the bank, 3 percent at the bank, and they need that high rate of return, they are fearful for their future.

Number three, they are lonely. Spend a little time on the phone with a lonely widow. Flatter her, flirt with her, do some favors for

her, balance her checkbook for her. And the next thing you know, you have access to her complete bank account. Telemarketing, infomercials, targeted advertising, the complexity of the financial marketplace really makes this work. I submitted for the record nine cases for the Committee's consideration in which targeting the elderly was the main modus operandi.

And I have suggested some things that work. Federal-State cooperation in terms of task forces, multistate actions, there is a Federal Department of Justice program called the National White Collar Crime Center, which is particularly effective. More regulatory oversight, raising public awareness in terms of basic financial survival skills, making clear that infomercials which occur on cable television are paid advertising.

White collar crime, emphasizing the fact that economic crimes are just as bad and in many cases worse than street crimes. The elderly widow who loses her life savings to a con artist I don't think feels any better about the fact that she wasn't hit over the head and her purse snatched. Technology, the con artists are using technology and the regulators and the law enforcement community ought to be using it as well. And finally, the small investor community. We have got to bring them back into the economy.

In conclusion, I would just like to tell you that in the Charles Keating case, in which my department was the first agency to bring suit under the securities laws, there was a memorandum to the sales force. And one of the sales tips was, always remember that the weak, the meek, and the ignorant are always the best targets. And I hope, Mr. Chairman, that there is a special place in hell for those who victimize the elderly. But in the interim, the States stand ready to work with this Committee and do anything we can to help you out.

[The prepared statement of Mr. McDonald follows:]

STATE OF CALIFORNIA
DEPARTMENT OF CORPORATIONS

Statement of G. W. McDonald
Chair, Enforcement Policy Committee
North American Securities Administrators Association
Assistant Commissioner, Enforcement Division
California Department of Corporations

EXECUTIVE SUMMARY

Statement of G.W. McDonald before the
U.S. Senate Special Committee on Aging

Washington, D.C.
May 25, 1993

The problem of affinity group fraud--that is fraud on ethnic, religious, and other cohesive groups--includes frauds targeting the elderly and retired community.

There are several factors which cause the elderly and retired community to be attractive targets for investment fraud;

1. Nest egg

The elderly and retired community has money in the bank, sometimes large amounts of it.

2. Fixed Incomes

The worst fear the elderly have is that they will run out of money before they run out of life. With bank rates at historic lows, it is an ideal time to pitch investments with a high rate of return.

3. Loneliness

Many elderly people are lonely and susceptible to con artists who will give them some attention to gain their trust, only to victimize them.

4. Widowhood

Women in their 60s and 70s were married in the 1930s and 1940s when the man handled the finances. After he dies, she is a sitting duck for con artists who tout their expertise and offer to handle her finances.

5. Telemarketing

Whether the con artist is a broker, a promoter, or just a small time chiseler, the tried and true three call system still works like a charm.

6. Infomercials/Targeted advertising

Con artists can buy a half hour on the local cable business channel, or on late night television, and can package their program to look like a news/interview format, when in fact it's purpose is to sell the investment product.

7. Complexity of the Financial Marketplace

Most people are confused about the complexity of financial products. They are desperate for help.

**What is to be done?**

1. Federal/State Cooperation

In an era of limits at all levels of government, we have to work together and the Congress can facilitate that process.

2. Multi-state Actions

The National White Collar Crime Center has an ambitious agenda of information sharing, technical assistance, training and investigative coordination in the white collar crime area, and deserves this Special Committee's support.

3. Regulatory Oversight

The broker-dealer industry has an important role to play in protecting the elderly. The Committee should work with the regulatory community to make sure that abusive sales practices are eliminated by the securities industry.

4. Raising Public Awareness

Nothing we could do would be more important than raising public awareness of the victimization of the elderly in the investment marketplace, and indicating ways the elderly can protect themselves.

5. White Collar Crime

We need to educate the prosecutors and the judges that economic crimes may be far more damaging to the elderly than street crimes.

6. Technology

The con artists are using modern technology, and we should fight fire with fire.

7. Small Investors

Capital formation is the mantra for the 1990s, and the elderly and retired community have got to have faith in the investment marketplace.

Mr. Chairman and Members of the Special Committee:

On behalf of NASAA, the North American Securities Administrators Association, and Acting California Commissioner of Corporations Brian Thompson, I appreciate the opportunity of testifying before the Special Committee this morning.

NASAA is a 75 year old association of the 65 state and provincial securities administrators from the United States, Canada and Mexico. Individually, we are charged with the responsibility for administering and enforcing securities laws within our various jurisdictions. Collectively, the members of NASAA work to maintain the integrity of the securities marketplace, to protect investors, and to curb abuses in the offer and sale of securities.

My name is Bill McDonald, and I am here in two capacities. As Assistant Commissioner in charge of the Enforcement Division of the California Department of Corporations, I am responsible for enforcing the California state securities laws, as well as other business regulatory statutes under the jurisdiction of the Commissioner of Corporations, through a staff of attorneys, investigators and accountants.

I am also Chair of the Enforcement Policy Committee of NASAA, which is charged with formulating enforcement policies and priorities for the membership, as well as developing and supporting multi-state enforcement projects to stop fraudulent activity in the securities marketplace.

Mr. Chairman, I commend you and the Special Committee for holding this hearing to explore the problem of fraud on the elderly.

## Defining the Problem

### The Elderly as a Community

Several years ago, NASAA identified and described the nationwide problem of affinity group fraud--that is, fraud on ethnic, religious and other cohesive communities.

In California, we have seen dozens of such cases, affecting the Hispanic community, the African-American community, the Asian community and its various subgroups, the fundamentalist Christian community, the Mormon community, the Jewish community, airline pilots, police officers, and the elderly and retired community.

What characterizes these cases is that the members of the group have a common bond and a sense of community, and con artists use that against them. In a complex and threatening world, people don't know who to trust, so they trust their own community. In doing so, they substitute their faith in the group for their normal business judgment.

The con artist establishes him or herself as a member or friend of that community by recruiting opinion leaders, by doing favors, by appealing to the special concerns of the group, by exploiting the unique fears of the group, or by targeting advertising or media appeals to the group. Before long, he or she has acquired credibility in the group, and assumes a position of trust.

The same techniques are used over and over again, because they work. Dispel fear by sounding sure of yourself and dressing and acting the part of the successful, self-made man or woman. Offer a ground floor opportunity that is tailored to the needs of the elderly--high return, no risk. The product or service is irrelevant so long as it sounds plausible.

Use the Big Lie technique of repeating the simple message like a mantra--"This is a chance for our community to get it's share of the American Dream." Capitalize on alienation from authority by emphasizing that the opportunity and the exclusivity of the deal require confidentiality. Give the group a sense of empowerment by involving them in the show--give tours of the properties, send glowing progress reports, give them some of their own money back and call it their monthly dividend or profit, give them finders fees for bringing in other investors, encourage them to mortgage their homes or cash in their insurance policies to invest more. Make the deal the focus of the community and get the community into a frenzy of excitement and hope.

When the authorities start sniffing around, tell the investors that the success of the deal lies in sticking together and not letting some bureaucrats mess up a good thing. Make excuses for delays. Send lull letters full of hope and promise--and lies. When people have gotten into a deal by substituting their faith for their judgment, they will stay loyal to it beyond all reason because the alternative is unthinkable and unacceptable.

In the end, it's always the same. The promoter ends up with the money and the investors aren't quite sure what hit them. Their most basic faith--faith in their group--has been shattered. Their anger and hostility is initially directed at the government for not letting the deal go forward, at least until they could get out. But gradually they must accept the fact that they have been had and that their life savings is gone. They have mortgaged their futures and destroyed any chance for a comfortable retirement.

In California, we get 5000-6000 complaints a year, and I read many of them. The stories from the elderly frequently involve abuse of trust, betrayal, despair and hopelessness. People who have never been lied to in their lives have a hard time accepting the amorality and cruelty with which a promoter or broker or telemarketer may have taken their life savings. They look to the government as their last hope, and find it hard to accept that there is no remedy in many cases and that their money is gone forever.

Why are the Elderly Victims?

If I were conducting a seminar on investment fraud techniques for aspiring con artists, Lesson 1 would be "Target the Elderly and Retired." I would give at least seven reasons why that community is the most vulnerable and the best pickings:

1. Nest egg

The elderly and retired community has money in the bank, sometimes large amounts of it. Why fool around with a 30 year old with only a few bucks when there are 70 year olds with hundreds of thousands or millions. The crime is the same and the time is the same.

2. Fixed Incomes

The worst fear the elderly have is that they will run out of money before they run out of life. With bank rates at historic lows, it is an ideal time to pitch investments with a high rate of return. Those conservative investors who were making 10% in CDs all through the 1980s are desperately concerned about earning 3% in the 1990s. They are so used to safety that they are easy pickings for any deal that is packaged as "high return, no risk, guaranteed, can't miss."

3. Loneliness

Take your time. Talk to them. Gain their trust. It's worth a few hours on the phone when you consider the potential rewards of complete access to the big bank account. You may be the surrogate son or friend to replace the valued one they lost. Make them feel important and needed. Then take every dime.

4. Widowhood

Women in their 60s and 70s were married in the 1930s and 1940s when the man handled the finances. After he dies, she is a sitting duck. Probably never even balanced the checkbook. Do some favors. Offer some advice. Be sympathetic. Flatter. Flirt. Tout your own business success and financial acumen. Offer to help her get a better return on her money. Then take every dime.

5. Telemarketing

Whether you are a broker, a promoter, or just a small time chiseler, the tried and true three call system still works like a charm. Get a list of elderly and retired people. First call introduce yourself and say that you are a financial adviser who sees a good deal now and then and could you keep them in mind if something comes along. Call again in 2-3 weeks to talk about how well all your deals are doing and that if he or she had been in on one of them, they would have made such and such a return on their money by now. Tease them that you think there is a big oil and gas (precious metals, real estate, high tech, whatever) deal about to come down and you will let them know. Third call they are yours.

6. Infomercials/Targeted advertising

Buy a half hour on the local cable business channel, or on late night television. Package your program to look like a news/interview format, but sell your product. Put an ad in the paper the serves Leisure World or other retirement communities. Offer a free seminar. Use a toll free 800 number. Make it look like you are just giving generic advice at first, and then put them in the deals that you are getting a commission on.

7. Complexity of the Financial Marketplace

Most people are confused about the complexity of financial products. They are desperate for help. Hang out your shingle as a Financial Planner. Put out a newsletter. Offer a toll free 800 number. Give free seminars. Keep it simple and generic until they trust you and then reel them in.

Case studies

Below are some of the cases which California has seen in the last few years in which the elderly were targeted or were the principal victims:

1. American Continental Corp./Charles Keating

Over $250 million worth of subordinated debentures in American Continental Corporation, the parent company of Lincoln Savings Bank, were sold to some 23,000 investors, many of whom were elderly and on fixed incomes. Many of the debenture purchases were solicited at Lincoln Savings branches, where the pitch was used that the investments were as safe as the bank, and investors were led to believe that they were insured by the United States government. Bank employees were given lists of names of individuals whose certificates of deposit were about to mature, and were given bonuses and commissions to solicit the customers by phone to switch from CDs to the debentures.

2. Bawcs Oil

Promoter made repeated cold calls to elderly victims until they agreed to invest in oil and gas limited partnerships which he was offering, and then sent Federal Express to their homes to pick up

the check before they could change their minds. Ten elderly investors testified at the criminal trial for securities fraud. The eldest victim was 85. The promoter was reported to have told a colleague that these people were going to die anyway and someone was going to get their money, so it might as well be him. 600 victims were taken for at least $11 million.

3. Tri-State Financial Group

In this case, a tax preparer/estate planner solicited his clients to invest in 106 alleged tax shelters in the form of limited partnerships, promissory notes, condominium units, and IRAs. He solicited over 400 of his clients to invest over $25 million by establishing a personal rapport with them and capitalizing on their loneliness and trust. One 87 year old woman, who had invested over $150,000 in his various schemes, was also induced to loan him money so that he could buy Christmas presents for his family. She was ultimately left destitute when all of her investments proved worthless.

4. (Name Withheld) Credit Corporation

We recently received a referral from the Legal Aid Foundation of Los Angeles about an individual who gains the confidence of elderly people he meets in church, and then convinces them to mortgage their homes to obtain funds to invest in trust deeds allegedly secured by real estate. Victims are told they are investing with Jesus and are promised 18% return on their investments. When the promised high returns are not forthcoming, the victims have been losing their homes, and some have been left homeless as a result.

5. Hill Williams Development Corp.

This scheme targeted elderly victims living in Leisure World, and involved 5,000 victims who lost $89 million in a massive ponzi scheme. Sales were made through a large broker-dealer

network which promised a 15% rate of return in limited partnership investments to develop real estate properties, and failed to disclose any risks involved. Advertisements appeared regularly on the local cable business channel, in the form of infomercials. A 74 year old retired meat cutter had to go back to work when dividend checks stopped. He reported that when bank interest rates fell to 3%, he and his wife looked for alternatives that would pay a higher rate of return. Many widows who had previously left financial matters to their husbands were victimized by smooth talking young salespeople who promised high monthly income with no risk. Many thought that seeing an ad on cable TV meant that the station had checked out the company and was endorsing it.

6. Jamie Stitt

Young promoter who targeted the elderly. When he found people who were trusting, he would ingratiate himself with them almost as a substitute son and offer to look out for their financial interests. He took hundreds of thousands of dollars from each victim, either offering to invest in securities for them or offering to let them invest in his financial consulting business called Senior Life. In reality, the money was used to support his personal expenses and his wife's catering business.

7. Sevitski & Associates

$20 million worth of working interests in oil and gas wells were sold to some 425 elderly investors. Many of the victims were encouraged to invest by testimonials from religious lay leaders. The deal turned out to be a ponzi scheme.

8. (Name Withheld) Environmental

Sale of stock by an insurance agent to his elderly clients. Many withdrew their funds from their insurance policies at the agent's recommendation to invest in the company, which was supposed to be about to market a process which would allow the recycling of freon from air conditioners and refrigerators. The agent met his customers at senior citizen centers and county fairs.

9. Home Equity Financial Group

$7 million ponzi scheme in which two real estate brokers offered promissory notes secured by deeds of trust paying 12-15% to their elderly and retired clients. They personally went to the homes of those who were too infirm to go to their offices. They forged names on documents, they refused to let investors cash out. One of the two promoters took every cent they had from two of his elderly aunts, such that one had to go back to work as a housekeeper even though she was past 70 years old.

**What is to be Done?**

The problem of fraud on the elderly is never going to be stopped entirely, but there are some techniques which have proven to be successful in other areas and which I recommend for the Special Committee's consideration:

1. Federal/State Cooperation

The Penny Stock Task Force involving the SEC, the NASD and the states has proven to be singularly successful in addressing a nationwide fraud problem. In an era of limits at all levels of government, we have to work together and the Congress can facilitate that process. The states have always had the small investor as a priority. Congress can direct the SEC to work with the states on this issue, in the manner of the Boiler Room Task Forces, Financial Fraud Task Forces, and Securities/Commodities Fraud Task Forces that have been successful around the country.

2. Multi-state Actions

The states are working together on a number of projects to attack white collar crime. Congress funds one of the most promising ones, which is called the National White Collar Crime Center (NWCCC). It is one of the RISS (Regional Information Sharing Systems) Projects under the auspices of the Department of Justice, Bureau of Justice Assistance. NWCCC has an ambitious agenda of information sharing, technical assistance, training and investigative coordination in the white collar crime area, and deserves this Special Committee's support.

3. Regulatory Oversight

The broker-dealer industry has an important role to play in protecting the elderly. The advice we always give people is to deal with regulated products and licensed professionals, and we have an obligation to make sure that abusive sales practices are eliminated by the securities industry. Suitability, supervision of agents, due diligence, avoiding conflicts of interest and making adequate disclosure all affect the elderly and retired customer of a broker-dealer, and they should be held to a high standard. We have received hundreds of letters complaining about the Prudential-Bache limited partnership programs of the 1980s which are the subject of a joint state/SEC investigation, and they all complain about sales practice abuses, and express their disappointment that a major national broker-dealer would abuse their faith and confidence so completely.

4. Raising Public Awareness

Nothing we could do would be more important than raising public awareness of the victimization of the elderly in the investment marketplace, and indicating ways the elderly can protect themselves. Most remedial activities stop further violations, but do nothing to alleviate the suffering of those who have been victimized already. In this country, every school should teach basic financial survival skills, and NASAA stands ready to assist this committee and the educational community in preparing such a curriculum. We also need to alert the present generation of elderly about the predatory practices of those who would victimize them and give them practical advice on how to conduct their financial affairs in such a way as to minimize their chances of being a victim. This can be done by the aggressive distribution of informational pamphlets, brochures, lectures at consumer fairs and seminars, the publication of general and specific press releases, and by making advisory resources available to the investing public. We should also make sure that infomercials are clearly identified as paid advertising.

5. White Collar Crime

With all the violence in our communities, we tend to minimize and trivialize non-violent economic crimes against the elderly. I don't think the retiree on a fixed income who loses her life savings to a con artist feels any better about the fact that she

was not hit over the head and her purse snatched. We need to educate the prosecutors and the judges that economic crimes may be far more damaging to the elderly than street crimes.

6. Technology

The con artists are using modern technology, and we should fight fire with fire. Public service announcements on cable television, investor education videos, education on how capital markets work on public television and coordination between public advocacy groups and regulators using sophisticated data bases to educate the public are proven techniques that could be greatly expanded.

7. Small Investors

Capital formation is the mantra for the 1990s, and the elderly and retired community have got to have faith in the investment marketplace. Many of them were burned in the market break of 1987, and many of them are being victimized every day in the kind of scams we have been talking about this morning. We need to give them confidence that if they enter the investment marketplace, they are not guaranteed a profit, but at least the investments have economic reality and they and the national economy may benefit from their participation.

## Conclusion

There should be a special place in Hell for those who victimize the elderly. The states stand ready to work with the Special Committee and other regulators to address this serious national problem.

I would be happy to respond to any questions.

The CHAIRMAN. Mr. McDonald, thank you, and thank you for those tips. We're going to have some questions for you in just a moment.

Senator Cohen, Mr. Diamond is your constituent, I wonder if you would like to introduce him?

Senator COHEN. Mr. Diamond has been very, very involved in educating not only the people of Maine about some of the risks involved in this, but also those individuals who are engaged in the selling of stocks and bonds in the States itself. He will point out, I hope, that he spends about 45 minutes lecturing on the subject of ethics to those who are about to go into the market as salesmen and brokers and so forth. I think that may be a bit unrealistic in dealing with States of a much larger population, but I think it sets a pretty good example for other States to follow.

Mr. Diamond, I want to welcome you here. I think your testimony will be very important for the people of this country, to explain what happened with First Investors in Maine and elsewhere.

## STATEMENT OF STEPHEN L. DIAMOND, SECURITIES ADMINISTRATOR, STATE OF MAINE

Mr. DIAMOND. Thank you, Senator.

Mr. Chairman, Senator Cohen, it is indeed a pleasure for me to be here and I very much appreciate this opportunity to testify about investment abuses affecting older Americans. Being from Maine, I am particularly gratified by the fact that Senator Cohen and some of the staff members, Mary Gerwin and Helen Albert, have shown such an interest in this problem, which is very encouraging to somebody in my position.

The message I want to bring is that investment abuses are not always the work of con artists who are engaged in criminal fraud. I think that's the common perception. There are certainly plenty of those, but that's not the extent of the problem. In Maine, the elderly lose more money from abuses committed by licensed persons selling lawful products. Much of this results from what I call—and this is not a recognized term—soft-core fraud, or from broker incompetence. I was going to spend a few minutes talking about the First Investors case as an example of soft-core fraud, but I think that's been rather thoroughly explored through Mrs. Pharr's testimony.

I would merely observe, however, that that was a situation involving a licensed company selling lawful products through sales representatives who were licensed. Furthermore, as Mrs. Pharr indicated, and as was our experience in Maine, most of the sellers were young, inexperienced, local people who themselves probably did not understand the products and indeed, rather tragically, sold to relatives and to neighbors.

Broker incompetence is a somewhat more obvious concept. The example that I would give would be of the broker who advised an elderly Winthrop, Maine couple, who had a very modest house and a very modest car, along with small pensions, to put all $50,000 of their savings into a speculative oil and gas partnership. When the couple came to us, the Securities Division, about 90 percent of their investment had been lost. This, by the way, was a broker from a very conservative, very well-known firm, which gives some indication of how widespread the problem can be.

How do we eliminate soft-core fraud and incompetence? The major message I would like to deliver is that we need to demand a higher degree of professionalism in an industry which is too frequently guided by the maxim that selling isn't everything, it is the only thing. We must look at the competency standards that we impose on stockbrokers. To my mind the junk bond case raises a very serious question of whether merely passing a limited exam should qualify one to sell mutual funds, when in fact you're dealing with someone's life savings, regardless of what the product may be.

The other component of professionalism is high ethical standards, and I think that's a somewhat more elusive goal. But they are certainly not fostered when you have firms willing to hire problem brokers simply because they are big revenue producers, as has been reported in the Los Angeles Times. High ethical standards are also not fostered by a major firm which allows brokers to use aggressive and deceptive cold calling practices to reach persons who are trying to avoid their calls, as we are finding in a current investigation.

Although there are certainly many highly professional people in this industry, there are nonetheless too many messages being sent that selling is more important than ethics. I think from the regulatory side we have to ask three basic questions. First, do brokers receive adequate training on their ethical responsibilities? Second, are there accepted industry practices which conflict with the notion that the broker's basic obligation is to act in the client's best interest? This is a point that I explore somewhat more in my written testimony. Third, do our enforcement efforts adequately drive home the fiduciary obligation of the broker?

Without trying to tackle these questions in the time allotted, I would submit that more needs to be done in this area of broker ethics. Senator Cohen has given the example of what we have tried to do—it's certainly a modest program—but basically we require every new broker located in the State of Maine, to come in before they get licensed and listen to a 45-minute presentation—what we consider to be our local morality play—on how we perceive their obligations to their clients. And it's proven, from what we can tell, quite successful.

Let me conclude by saying that financially unsophisticated older persons often put total trust in brokers. They frequently do not read or cannot understand prospectuses, and thus—and this is a point that I think is critical to understand—often their only real protection lies in the competency and the honesty of the broker. When that protection is absent, the consequences are severe, since the savings of the elderly do not represent a renewable resource, as we've heard today, and accordingly they cannot write off their losses as lessons learned for the future.

Thank you very much.

[The prepared statement of Mr. Diamond follows:]

H. Donald DeMatteis
*Superintendent*

Stephen L. Diamond
*Securities Administrator*

DEPARTMENT OF PROFESSIONAL AND FINANCIAL REGULATION
**BUREAU OF BANKING**
SECURITIES DIVISION
(207) 582-8760

STATEMENT OF STEPHEN L. DIAMOND

SECURITIES ADMINISTRATOR
MAINE DEPARTMENT OF PROFESSIONAL & FINANCIAL REGULATION

Mr. Chairman and Members of the Committee:

My name is Stephen L. Diamond. I am the Securities Administrator for the State of Maine, and I appreciate your invitation to offer my thoughts on investment abuses affecting the elderly. I should emphasize that the views I express in this testimony are mine alone, based upon almost eight years as a state securities regulator.

Introduction

There is probably no scenario more familiar to securities regulators than that of the older person, who, in search of a higher income on which to live, loses all or part of his savings in a fraudulent or inappropriate investment. As with many problems, this one exacts its greatest toll on those who can least afford it. It is the senior citizen of limited means, who most needs to squeeze out every extra penny of income, who is devastated by any loss of principal.

This is not a new phenomenon, as interest rates have generally been trending downward for more than a decade, and during that period, the quest for higher yields has intensified. There can be no doubt, however, that the pace has greatly increased in recent months. The threat of disintermediation even appears to be leading some bankers to rush for the exits, eager to get their money out of banking and into the securities and insurance businesses.

We must all fear that under these conditions the stage is being set for thousands, and perhaps millions, of older Americans, currently familiar only with bank deposits, to learn an unpleasant truth about most other investments - at the end of the day, it is possible to have less money. The old Will Rogers' quip - "it is not the return <u>on</u> my principal I am worried about; it is the return <u>of</u> my principal" - may take on personal significance for many of your constituents should interest rates rise and stock and bond prices fall. Those who have invested in stocks and bonds, moreover, will seem fortunate compared to those whose desire for a higher yield led them into scams.

While it is impossible to predict the magnitude of the problem, experience tells us that hardships will surely occur among older Americans when economic conditions change. Thus, I think it fitting that this Committee inquire into the safety of retirement investments. As to any insights I might offer, I feel competent only to address investment abuses encountered by the elderly. To the extent that your inquiry also extends to the safety of employer pension plans and the soundness of financial institutions holding retirement funds, I have no expertise in those areas.

Types of Investment Abuses

While the public focus is often on scams, policy makers must recognize that investment abuses run the gamut from deliberate fraud to broker incompetence. Although more like an unbroken continuum, I find it helpful for discussion purposes to put cases into one of three categories: hard-core fraud, soft-core fraud, and incompetence. Since fashioning solutions requires an understanding of the different problems, I shall offer a brief example of each type of case.

Starting with my "hard-core" example, Christopher Mussenden, whose tenure as an insurance agent and a stockbroker was characterized by an ability to secure the confidence of older investors, is currently awaiting sentencing on a fraud conviction in the Federal District Court in Portland. After years of selling rather conventional products, Mussenden discovered that fictitious investments were more profitable. Creating a totally bogus "trust," which he blessed with the attributes of safety and a high yield, Mussenden advised his older, less sophisticated clients to purchase interests.

The often total dependence of the elderly on those whom they choose to trust for investment advice can be clearly seen in the reaction of the first Mussenden client we called when we got wind of his illegal scheme. This was an 83-year old retired school teacher who lived alone and had no close relatives nearer than California. When we broke the news of Mussenden's activities to her, the investor wept, not simply because of the loss of her money but also because she had been betrayed by a friend, the one person on whom she felt she could rely. In short, this was a case of blatant and deliberate investment fraud on the elderly.

My soft-core case involves a company which creates, manages, and sells mutual funds. During the latter half of the 1980s, the company heavily marketed its two junk-bond mutual funds to several thousand persons in Maine. Most of the sellers were local people with no prior securities experience, and many of the purchasers were not really investors, in that their only prior experience was with bank accounts and conventional insurance products. When the junk-bond market collapsed in 1990, many of these people suffered a substantial loss of principal.

Although the company might well disagree with this characterization, it is my view that, in addition to selling the funds to investors for whom they were unsuitable,[1] much of the marketing consisted of extremely misleading half-truths designed to give the investment a false aura of safety. Some examples follow.

[1] An investment is generally deemed unsuitable if it is inappropriate in light of the investor's financial situation and investment objectives.

- Purchasers were told that the bonds owned by the funds were guaranteed by the corporations which issued them; they were not told that this was true of all bonds (indeed, of virtually all debts) and that the "guarantee" was of limited value with highly leveraged companies.

- Purchasers were led to believe in the safety of the funds by drawing their attention to the bonds of companies with high name recognition and visible assets, such as Eastern Airlines; they were not told that these companies were heavily in debt, and thus, their bonds carried substantial risks.

- Purchasers were told that many of the fund shareholders were "Trustees, Custodians, or Guardians" who "have a legal responsibility to choose prudent investments for minors and others;" they were not told that many of the custodians were ordinary people who were simply buying for their children.

- Purchasers with their money in bank CDs had those investments compared to an investment in the junk-bond funds; they were not told, however, that money in the bank was much safer because of the federal insurance.

Through the use of scripts, which the salespersons were often required to memorize, the sellers were trained to compare the funds' yields to those for pass book savings accounts, CDs, and savings bonds. With this emphasis on receiving a much higher income incorporated into a presentation which made the investment seem safo, the marketing pitch was ideally suited for older investors, and they represented a substantial percentage of the purchasers.

I put this case in my "soft-core" category because it involved a licensed company selling legitimate products through licensed salespersons and because its statements to investors were arguably more misleading than outright false. More significantly for your purposes, I think many of the objectionable practices can be found elsewhere in the securities industry, although not nearly to the extent that they existed here. I shall elaborate on this point later in my testimony.

As one of the first cases I encountered as Maine's Securities Administrator, my "incompetence" candidate demonstrates that this problem is not of very recent vintage. The complainants were a couple in their late 70s, who, at the time of the investment, had a modest house, a modest car, very modest pensions, and about $50,000 in savings. Knowing that they were extremely eager to increase their income, their broker, who worked for a large, generally conservative firm, recommended that they put virtually all of their savings in a single oil and gas partnership. At the time of the investment in the early 1980s, these partnerships were hot items; at the time the couple came to the Securities Division, they had lost about 90% of their money.

I categorize this as incompetence, rather than as an unforeseeable event, because the broker, however bullish he was on the investment, should have perceived it as much too risky for an elderly couple's entire nest egg. Making matters worse, the broker ignored the financial suitability requirements which Maine and other states required as a condition to registering the partnership interests. Indeed, characterizing the broker as merely incompetent may be overly kind in light of the fact that the investment carried a generous commission.

Dealing with Investment Abuses

As suggested earlier, different types of investment abuses require different responses. In addressing hard-core fraud, I have nothing to add to the excellent suggestions set forth in Bill MacDonald's testimony. In fact, we were successful in the Mussenden case because we followed two paths recommended by Mr. MacDonald First, the investigation was a cooperative effort between state securities regulators in Florida and Maine. Second, when it was determined that it would be easier to prosecute the case federally, we received the enthusiastic participation of the U.S. Attorney's Office in Maine.

Devising solutions for what I have classified as soft-core fraud and incompetence is more difficult because the situation is often less clear cut. In some instances, establishing the existence or severity of wrongful conduct involves defining the limits of acceptable behavior for securities practitioners. Thus, while hard-core fraud is largely an enforcement issue, these other abuses are more likely to warrant a regulatory response.

To get to the heart of the matter, I believe that many investment abuses stem from a basic tension in the retail securities business. On the one hand, the industry carefully cultivates the image of the broker as essentially a fiduciary, namely, an expert in his field committed to acting in his client's best interest. On the other hand, too much of the industry is driven by a marketing ethos in which making sales is the overriding, if not the only, goal. Although similar problems exist in other fields, this conflict between the image of the financial professional and the reality of the product salesman is particularly severe in the securities industry because of the transaction based system of compensation.

In my view, the case of the mutual fund company is the perfect example of the marketing mentality run wild. The firm almost exclusively hired local people with no prior securities experience. Its training produced less of a real understanding of investment products and more of an ability to sell according to a canned script Rather than teach its salespersons the difference between investment grade and junk bonds, it taught them how to overcome buyer resistance - even when that resistance was based on the fear that the product might be too risky.

The pitch was kept simple. Compare the yield on the funds to that being earned on CDs, savings bonds, etc. One size could fit all. The product was ideal for seniors seeking higher income and for young families trying to save for college. According to one former salesperson, "risk" was not to be mentioned.

Mostly earnest, mostly well intentioned, and mostly young and inexperienced, the sales people were pressured to come up with names of potential purchasers. It is not surprising that sales were often made to neighbors and relatives, many of whom were older investors seeking to augment their retirement income.

While the mutual fund company in my example may have taken it to an extreme, overzealous marketing is not an isolated phenomenon. Furthermore, the harm which can occur when product salesmen masquerade as financial professionals is most likely to impact older Americans who have accumulated substantial nest eggs without accumulating any investment experience. In an investigation we are conducting of the cold calling practices of a major Wall Street investment firm, the recipients of the calls, who are almost entirely business people, demonstrate considerable cynicism about the nature of the callers. By contrast, the mill worker who is never approached by a broker until after he has received a lump sum retirement payment is less equipped to judge the credentials of a "financial consultant."

Having articulated my view of the problem, I feel far less confident that I have the solutions. As a general proposition, I think we need to make the image a reality. Put differently, the regulators and industry leaders need to raise the level of professionalism in the securities business. This is not to suggest that there are not many highly competent, highly ethical brokers. Rather, it is to suggest that we need to elevate the minimum standards of professionalism required of securities practitioners.

Professionalism consists of two elements - expertise in one's field and adherence to high ethical standards. I shall briefly address each.

As my "incompetence" category suggests, some abuses result from the broker's lack of understanding of the investment being recommended. This concern is particularly great in an industry which constantly devises new products and investment strategies. To its credit, the National Association of Securities Dealers ("NASD") is seeking to address this aspect of the problem through the development of continuing education and/or assessment requirements.

A more fundamental question is whether the entry level standards are sufficient. With no minimum educational requirements, ensuring broker competence rests entirely with the tests developed and administered by the NASD. (Federally registered investment advisers are not subject to any competency standards, and thus, they need not even be literate.) Furthermore, if a broker is willing to restrict his activities to the sale of certain products, only a more limited test need be taken.

While I have doubts about the minimum competency standards for all categories of licensees, I have particularly serious reservations about the test, known as the Series 6 exam, which may be taken by brokers whose securities activities extend only to the sale of mutual funds and variable annuities. Judging the exam by its results, it was clearly not sufficient to ensure that the sales force in my mutual fund example were able to understand the risk characteristics of junk bonds or of junk-bond mutual funds. Had there been such an understanding, it is likely that at most there would have been minor problems, notwithstanding the sales oriented training given by the company.

The very concept of allowing mutual funds to be sold by people who do not have an in-depth knowledge of the securities in which the funds invest strikes me as flawed. The potential danger is greatest for less financially sophisticated people living in rural areas, since the only "securities professionals" with whom many of them will deal will be mutual fund sellers. The vast majority of Maine's new, in-state licensees only have the Series 6 registration at the federal level. Yet, they often hold themselves out as financial consultants, suggesting far greater expertise than actually exists. Furthermore, even if they are selling only limited types of investment products, they often deal with people's life savings, a matter of considerable importance.

On the ethical front, we should question all industry practices which interfere with a broker acting as a fiduciary. Ideally, in making recommendations to clients as a financial professional, a broker should conduct a thorough inquiry into the client's situation and recommend that course of action which best suits the client's needs. Anything which conflicts with that ideal should be suspect.

Once again, my mutual fund case provides an example of a specific issue. In that instance, the Maine salespersons were only selling a limited number of proprietary funds, and as noted previously, were often encouraged to push the high yield funds. With a relatively small number of products from which they could earn commissions, the brokers could not select from the universe of available investments those which were optimally suited for the particular clients. One may also question whether the brokers could objectively evaluate funds underwritten by an affiliate of their employer. Indeed, having proprietary product sellers seems inherently inconsistent with the concept of the broker as a fiduciary who puts the interests of the client first.

Sales incentive arrangements furnish another example of the divergence between image and reality in the securities industry. Rewarding a broker with a free trip for making a prescribed number of sales of a particular investment hardly seems conducive to individualized advice based on the client's needs. It seems no more justified than a hospital giving surgeons special incentives for meeting a quota with respect to a particular type of operation. If we are to allow this type of practice, then we should require it to be broadcast loudly enough to ensure that even the least sophisticated investors are aware of it.

The foregoing is intended less to raise the specific issues than to call attention to the broader need to address the schizophrenic nature of the industry and the manner in which it is regulated. If we are to prevent abuses, we must develop a clearer concept of the broker's responsibility to the client, and we must take a hard look at those practices which do not fit that concept.

Apart from dealing with specific practices, we must work to bring about a change in the underlying mentality of segments of the industry. Although very preliminary, our inquiry into cold calling suggests that at least one major firm is willing to allow its employees to use high pressure and deceptive practices just to get through to prospects seeking to avoid their calls. When a firm sends those kinds of signals, one cannot be very confident that upon finding a receptive ear, the brokers will be guided by the highest professional standards. This same concern about the priorities of some of those in the industry is reflected in the Los Angeles Times story about the willingness of some securities firms to hire brokers with long disciplinary histories if they are big producers. If the story is accurate, the message being sent by the firms is clear and not very comforting.

In terms of oversight, it can be argued that this is a rather heavily regulated industry. The real question, however, is whether that regulation is guided by a clear and consistent vision of how the industry should operate. In my view, that is not the case, and it will not be the case until there is a commitment to the proposition that adherence to fiduciary principles must always take precedence over marketing considerations.

Testimony of this nature poses the danger that one will overlook the many conscientious people who provide competent and responsible investment services in this country. Thus, I should emphasize that my quarrel is not with this majority but rather with those segments of the industry which encourage or tolerate practices which do not put the interests of the client first.

To conclude, protecting the elderly from investment abuse requires more than chasing crooks, as important as that activity may be. We must also carefully scrutinize certain aspects of the securities industry to ensure that they are consistent with high standards of professionalism. While that observation does not apply exclusively to the elderly, the reality is that older persons of modest means often suffer the most from fraudulent and abusive practices. These individuals tend to have the least financial sophistication and thus the greatest dependence on others for advice. More significantly, their savings do not represent a renewable resource, and accordingly, they cannot write their losses off as a lesson learned for the future.

The CHAIRMAN. Thank you, Mr. Diamond.
Mr. Guthary.

## STATEMENT OF BARRY C. GUTHARY, PRESIDENT, NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION; DIRECTOR, SECURITIES DIVISION, MASSACHUSETTS SECRETARY OF STATE

Mr. GUTHARY. Mr. Chairman, Senator Cohen.

I think my colleagues have adequately gone through the vulnerability of the aged to fraud and abuse. Mr. McDonald specializes in enforcement and Mr. Diamond has made us all aware of the abuses that come from licensed people selling lawful products.

I think I would from NASAA's point of view like to emphasize that other than the regulatory component, we need a strong education component. The problem that we're identifying is only going to get worse. I think all demographics suggest that the American population is aging, and therefore the group that is the subject of today's hearing is going to get far larger in size in the next two decades.

Also, the educational component of investing has not kept up with the Federal tax laws at all. The decisions made in the late 1970's and early 1980's to basically revamp the pension programs of the United States and go from defined benefit programs to defined contribution programs, and at the same time to establish individual retirement accounts and so forth, all were I think very sound policies to reverse the trend of using Social Security as the primary means for financing older age living.

However, it did not have any kind of a component of realizing that this meant that since the Federal Government was forcing the decision of investing to the individual away from what had traditionally been institutional investors, that is, that pension programs are now largely self-directed, and produce lump-sum payments, and IRAs, which have been very popular, and continue to be, are totally self-directed, as Mr. Us acquainted us with. I think his entire program was going through what should have been a tax-deferred vehicle.

And that, I can only imagine, will get worse. So I think I would emphasize, from NASAA's point of view, that we really see four prongs to the battle here. One is to produce better disclosure documents. I think one of the things all regulators are coming to realize is, and it's not just related to the elderly, that the prospectuses that we have developed are primarily geared toward Wall Street, not toward individual investors. And they are vastly too complicated, and we need to simplify them. Certainly, any one of the panelists today should have been able to read them in a rather simple way and gotten the information they wanted from them.

Second, I would emphasize that we need to pursue Mr. Diamond's suggestion to better train the securities sales forces, and make them aware both of their products and of their ethical responsibilities. We also need to, I think, step up protection at the Federal level in this area. One thing I do hope is that the Congress can pass this year the investment advisor bill now before the Congress to greatly expand the SEC's power over the investment advisor area.

Third, we need to increase enforcement. We don't need new rules. Most of the rules are in place in terms of suitability and so forth. It's really a matter of enforcing them more effectively.

And lastly, I think what the States are trying to do through NASAA and several of our committees is to educate people. That really is the primary basis here. If people are not educated, and there is such a large percentage of the population, now are not financially sophisticated, we will never have enough enforcement money to protect them. They have got to be basically the first line of protection. As we have seen today, I don't think that's the case here.

And I would emphasize that one of the things this committee could do is to watch Congressional legislation with an eye toward that. Because tax committees don't tend to think of this, they tend to think of tax implications. And I think one of the things we have to realize is that when we're helping people to build up a nest egg, we've got to realize that we also have to help them to invest it wisely.

Thank you.

[The prepared statement of Mr. Guthary follows:]

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

One Massachusetts Avenue, N.W. Suite 310
Washington D.C. 20001
202 737-0900
Telecopier 202 783-3571

NASAA

STATEMENT OF BARRY C GUTHARY

PRESIDENT,
NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Mr. Chairman, Senator Cohen, and Members of the Committee:

My name is Barry C. Guthary. I am president of the North American Securities Administrators Association (NASAA) and director of the Massachusetts Secretary of State's Division of Securities. In the U S., NASAA is the national voice of the 50 state securities agencies responsible for investor protection and the efficient functioning of the capital markets at the grassroots level. I appreciate the opportunity to appear before you today.

Mr Chairman, Senator Cohen, and Members of the Committee, I commend you for this effort to focus national attention on the very serious issue of investment fraud and the elderly There may be no single greater -- and preventable -- cause of dependency on the part of older Americans than the loss of savings to financial fraud and abuse In fact, it has been suggested that the financial ruin brought on by investment swindles is one the primary "gateways" to a host of other abuses against, and problems for, the elderly, including returning to the job market in low-paying jobs in order to make ends meet, the loss of a home, forced institutionalization in substandard nursing homes, malnutrition, and denial of needed of medical care. While there are many factors that may contribute to the loss of independence and the declining quality of life of an elderly person, few are as avoidable as investment scams.

### *INVESTMENT FRAUD AND ABUSE: AN OVERVIEW*

It has been estimated that investment swindlers take the American public for tens of billions of dollars each year. Why is there runaway investment fraud in the U.S. today? First, the number of Americans looking for investment opportunities has risen. Second, the range and diversity of investment instruments has grown as well. Some observers have called it "financial instrument overload," where even the most sophisticated among us have been thrust into a new and complex world of products for which we have no background to make the proper judgments. There is so much choice in the financial world today that many consumers find themselves utterly confused about where to put their savings and, as a result, often turn to others to make those decisions for them.

And, there now is strong potential for the investment fraud problem to grow even more severe. In these days of low interest rates, more and more savers are taking their money out of low-bearing bank accounts or certificates of deposit (CDs) and plunking it into the stock market in the hopes of earning better returns. But, what these small investors may not know is that the vagaries of the market may not be their only risk. Although the vast majority of brokers are honest and dedicated to the interests of their clients, there also are a number of unethical operators in the industry, as well as out-and-out con artists posing as legitimate members of the financial industry.

As my colleagues on this panel each will discuss in greater detail, there are two major problem areas of concern to state securities regulators (1) ***outright fraud*** (such as theft of customer funds) committed by those who operate outside of the regulatory system designed to protect consumers from financial fraud and abuse; and (2) equally troubling (though often no less disastrous) ***"abusive" practices***, such as selling products to investors for whom they are unsuitable or inappropriate, unqualified financial planners or brokers, the lack of proper disclosure, and so on. The concerns here apply equally to the brokerage industry and to the investment advisory/financial planning industry

### *INVESTMENT FRAUD AND THE ELDERLY*

Investment swindles are practiced against all age groups, against both men and women, and against both the well-educated and the poorly-educated -- there are no restrictions to joining the club of those who have become the victims of investment fraud. Still, it most often is the older person who is the victim.

Why are the elderly at such risk?

- *First*, the "Willie Sutton effect" is at work here. Sutton is the bank robber who, when asked why he specialized in bank jobs, said: "Because that's where the money is." Americans who are nearing retirement age and already retired comprise the population group most likely to have or to receive accumulated savings, lump sum pension pay-outs, insurance "windfalls" (usually after the death of a spouse) and have either substantial equity in their home or "free and clear" ownership of the same. Even elderly individuals of what might appear on the surface to be limited income and minimal circumstances may have substantial (though illiquid) assets. The U.S. Census Bureau's Survey of Income and Program Participation (SIPP) provides a good indication of why it is that the elderly are targeted by con men: 1988 data reveals that the median net worth rises from about $6,000 for householders younger than age 35, to $57,000 for those aged 45 to 54, and to and just over $80,000 for householders aged 55 to 64. Median net worth reaches its height at $83,500 for householders aged 65 to 69, and then starts to drop again slightly.[1] In short, elderly Americans control a substantial and increasing portion of the nation's wealth. It is for this reason that con artists see older Americans as their best prospects.

- *Second*, many of the current generation of older women are unprepared for the financial responsibilities that are thrust upon them in later years. Many elderly women find themselves in the position of having to assume control of their financial destiny after the death of a spouse. Since many of today's older women had little or no training about even the simplest of money matters, they often can be gulled into trusting a sweet-talking con artist who offers to take care of such worries for them.

- *Third*, increasingly sophisticated technology makes it easier for swindlers to target older Americans. The day is long past when con artists relied on obituary columns and newspaper announcements of retirements to identify potential victims. (It is true that some swindlers still operate this way.) Detailed personal information about the elderly is available by computer to con artists who are able, among other things, to single out recent retirees, recipients of pension plan pay-outs and insurance "windfalls," individuals with substantial equity in their homes, survivors of deceased spouses and so on. Sophisticated, computer-generated lists give swindlers the means by which to zero in on potential victims. In fact, a recent survey of mailing lists available for purchase include such categories as nursing homes arranged by state, and retired and semi-retired individuals sorted by zip code.

- *Fourth*, con artists now "narrowcast" their appeals to specific segments of the investing public, including the elderly. In much the same way that cable television channels have emerged to target individuals with certain interests (e.g., the Financial News Network, the Disney Channel, etc.) so too have swindlers focused their pitches in order to gain maximum effect with specific groups. It is for this reason that a growing number of con artists "specialize" in ripping off older Americans and, in order to do so, have developed highly-polished and persuasive pitches that prey on fears about maintaining a comfortable lifestyle on a fixed income, surviving in an era of low interest rates, affording decent medical care, the death of a spouse, and providing for spouses and children.

While there are no statistics on file as to the precise number of America's elderly citizens who are robbed each year in illicit investment schemes, there is ample anecdotal evidence to suggest that the problem is pervasive. State securities regulators around the country report that the elderly make up a disproportionate share of the number of victims in their investment fraud caseload. In fact, it has been estimated that, while people over 65 constitute only 12 or 13 percent of the total U.S. population, they make up approximately 30 percent of all scam victims.[2]

Consider the following examples which illustrate how it is that investment frauds target the elderly:

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[1] Charles F. Longino, Jr. and William H. Crown, "Older Americans: Rich or Poor?," American Demographics, August 1991, pp. 48-52.

[2] See, Michelle Bekey, "Dial S-W-I-N-D-L-E," Modern Maturity, April-May 1991, p. 31, and, A Report of the Chairman of the Select Committee on Aging, U.S. House of Representatives, 97th Congress, 2nd Session, Report No. 97-347, p. III

- An Oregon man who monitored the obituaries in the local papers in an effort to identify surviving spouses to whom he would pitch his insurance and financial planning services, was put out of business last year by the Oregon Department of Insurance and Finance's Division of Corporate Securities. One of the services offered by the self-proclaimed financial planner was the preparation of a "living trust," a document which required that a person list all of his or her financial assets. Armed with this information, the planner would recommend investments which he would manage on behalf of the investor. His last victim before being caught by authorities was an 84-old woman he first approached with some modest investment opportunities. After befriending the widow, he soon began to run her affairs and moved her out of her home and into a nursing home (which she did not want or need). He sold all of her possessions, and over the course of six months, persuaded her to loan to him or invest with him a total of $265,000, most of which he gambled with and lost in the commodities futures market. The man was arrested and charged with criminal violations. He spent over 60 days in the Marion County jail while awaiting trial and then pled guilty. He recently was sentenced to five years probation, ordered to pay restitution, and was prohibited from any future securities or insurance activities in the State of Oregon.

- The Colorado Securities Division moved to shut down a Boulder-based corporation, which, using the fictitious name "Senior Citizen Information Center," offered and sold trust deed investments through so-called "living trusts" marketed to elderly people living primarily in the Boulder area. The elderly victims in this case were told that because a living trust is the only way to avoid probate, if they invested $10,000 or more in the trust deed investment the company would prepare a living trust as a gift for free. (Without such an investment, the company would prepare a living trust for a fee that ranged from a few hundred dollars to over $1,000.) Promotional materials, which were particularly appealing to elderly investors, read:

  *"WHAT'S BETTER THAN MONEY MARKETS?*

  *A tax deferred income producing savings plan designed to meet the needs of modern thrift-minded people who require safety of principle (sic), and interest rates which are sufficient to offset inflation.*

  *This income producing asset is.*

  *A FULLY NEGOTIABLE PROMISSORY NOTE, SECURED BY A DEED OF TRUST ON PRIME COLORADO IMPROVED REAL ESTATE ..*

  *A TITLE INSURANCE POLICY AND HAZARD INSURANCE*

  *A GUARANTEED INSURANCE COMPANY ANNUITY ...*

  *A MONTHLY CASH FLOW TO THE INVESTOR .*

  *AND TAX-DEFERRAL AT YOUR CHOICE, BY FIRST-IN, FIRST- OUT ACCOUNTING ...*

  *AND, MOST IMPORTANT, EARNINGS OF UP TO 29% OR MORE AVERAGE ANNUAL RETURN ...*

  *ALL WITH NO FEE TO THE INVESTOR!!!!*

  *A SUPERIOR WAY TO ACCUMULATE MONEY"*

  In all, at least 151 persons, most of whom were elderly with little or no investment experience or sophistication, invested at least $3.4 million in these real estate trust deeds. Most of the investors lost a substantial portion of their funds and the promoters ultimately were convicted of securities fraud.

- Retirement seminars attended by former AT&T employees were used to lure 43 Arizonans into investing in an Idaho hydroelectric power plant. This limited partnership investment was touted for the tax credits investors would receive. Investors were told that the partnership would obtain low water flow insurance to protect the project in times of drought. Representations were made in the offering materials that the insurance would be in place before investor funds were released from escrow. In fact, the drought insurance never was purchased. In 1991, after several dry years, the partnership went into foreclosure and attempted to collect partnership liabilities from the investors.

- An Arkansas City, Kansas securities broker recently swindled 30 elderly Kansas residents out of more than $360,000 by convincing them to invest in what he described as "safe investments in government-backed GNMA's (Government National Mortgage Association) that would provide a monthly income." The broker created false purchase tickets and confirmation tickets. Proceeds from the elderly investors were placed into his personal and business accounts. The investors were sent small monthly interest payments which were made from his business account. Customers who became suspicious of the payment method were told that the insurer was paying the broker directly for the interest and that he in turn was paying the investors. In the end, the broker spent all of the victims' principal investment on his own personal expenses. The Office of the Securities Commissioner charged the broker with 47 counts of securities fraud. In October 1992, the broker was sentenced to serve eight to 40 years in jail and ordered to pay $361,000 in restitution.

- A Carson City, Nevada man was charged with 70 counts, including racketeering and securities fraud, for his role in a scheme that bilked 16 elderly investors out of more than $1.5 million. The Nevada Secretary of State's Securities Division reported that the man met his elderly victims through this estate planning business, in which he offered living trusts. After bringing in the victims through the living trust side of the business and learning of their financial circumstances, he suggested that they invest their cash in another company with which he was affiliated. Investors were guaranteed a 12.5 to 15.5 percent return on their investment and were told that their investments would be protected by the company, which had $82 million in oil and gas holdings. What investors were not told was that the company already had assigned its interests in the oil and gas wells to third parties before selling the securities.

- A Las Cruces, New Mexico self-proclaimed financial planner was sentenced to nine years in prison for swindling $260,000 out of one her elderly clients. When the planner's business began to falter and she needed some quick cash, she looked over her list of more than 200 clients and selected the elderly woman as her target because of their close personal relationship and because she knew that the elderly woman was dissatisfied with the interest she was earning on her certificates of deposit. The planner contacted the elderly woman and recommended investments which she promised would return 12 percent on the principle invested. The 76-year old woman agreed to turn over her money to the planner for investment purposes. When her daughter became suspicious due to the lack of monthly account statements, the State Securities Division was asked to investigate. What the Securities Division found was that the planner was not registered to do business in the state and that the elderly woman's money was not invested, but rather was used for the personal and business purposes of the financial planner.

These examples serve as just a small sampling of the hundreds and hundreds of cases state securities regulators investigate each year in which the elderly are the targets of investment fraud and abuse. The files of state securities agencies are filled with tragic examples of senior citizens who have been cheated out of their savings, insurance payouts after the death of a spouse and even the equity in their homes.

One convicted felon explained how he ruined the lives of hundreds of Americans, most of them older people, by stealing millions of dollars from them. He ultimately went to jail for selling bogus oil leases and precious metals. Here, in his own words, is how he carried out his scheme:

*"I typically got victims from a 'lead' company that collects and sells names of people who've at some point sent away for information on investments The key is to become friends with the victim first I always talked to someone several times before ever asking for a sale. I asked them about their life, listened to their stories, kept them company, flattered them "Edie, you couldn't possibly be 75 years young Why my wife is only 35 and you sound just like she does over the phone!' Once they were my friends and trusted me, I could sell them until they ran out of money*

*One con was the 'living legacy': 'We're talking about the opportunity of a lifetime, Fred I have a friend, Dick Jeffreys, who buys four shares every month. Do you know why? Because he has four grandchildren He told me just the other day, 'John, I'm so glad I met you because I know when those kids get those checks after I die, they're going to remember their grandfather.' Isn't that what it is all about, Fred?'*

*But my most ruthless approach was targeting Alzheimer's patients I talked to people over a series of days, writing down everything they said The next day I called them back and asked about something specific they had mentioned the day before. If they couldn't remember it, I knew their brain was gone So on the third day, I'd call and say, "Joe, this is John What's the problem, Joe? Where's the $25,000 you agreed to wire me last night?" The oil-well leases?' Nine times out of ten they sent the money out of embarrassment ..."*[3]

I can assure you that this is not an atypical story in any state securities agency. We all have seen this -- and worse -- as we unravel cases of investment fraud targeting the elderly. And, equally insidious is the problem of abusive practices involving the elderly Examples here abound. Brokers advising elderly investors to put their funds into risky limited partnerships because of the high commissions paid to the salesperson. Ads touting allegedly risk-free "collateralized mortgage obligations" and other investment products as safe alternatives to certificates of deposit. My colleague in Kansas explained the problem:

*"Over the last 14 years I have seen hundreds and hundreds of elderly citizens swindled. And the cases where the elderly were specifically targeted, or where there is a disproportionate number of elderly among the victims, some type of fiduciary relationship almost always is involved These cases usually involve a licensed professional, such as a registered securities broker, an investment adviser, an attorney, etc who guide these elderly victims into unsuitable or unauthorized transactions, engage in churning their accounts, steal their money through fraudulent and confusing transactions, or simply take their money by removing it from their accounts for phony products or fees*

*Perhaps the biggest threat to the financial assets of the elderly comes from those whom the elderly have grown to trust Certainly, the boiler room scams are a risk for the elderly. But damage from these con artists usually is limited to a relatively limited number of transactions which take place over a relatively short period of time Fiduciary-related crimes, on the other hand, tend to operate over a long period of time and go undetected until the victim's assets are completely depleted "*

The point here is a simple one: Older Americans are the No. 1 target of investment con artists

### *THE ROLE OF STATE SECURITIES REGULATION*

Overseeing the multi-trillion dollar investment marketplace in the United States is an enormous task that directly affects the financial well-being of millions of Americans and requires the close attention of the federal and 50 state governments. While the federal Securities and Exchange Commission (SEC) rightfully commits its resources to broad, market-wide regulatory activities, state securities agencies devote the bulk of their efforts to those regulatory and enforcement issues which most directly affect small investors, many of whom are elderly.

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[3] Bekey, p 38

Today, state securities agencies bear the primary responsibility for preventing fraud and abuse in the sale of all but the largest securities offerings. State securities regulation provides a "safety net" for small investors. It is the front-end licensing and registration activities of the state agencies that work to spot and stop fraud and abusive practices before the money is gone. Most states review new stock offerings and apply substantive standards in order to screen out those that are blatantly fraudulent and abusive. In doing so, state securities agencies protect small investors before the money changes hands.

Even when disregarded by a con artist, state registration requirements still work to reduce the toll of investment fraud. Such schemes often are shut down through a "failure to register" action, which provides state securities regulators with considerable leverage in minimizing the losses of investors. Many states also have broad cease and desist authority to move swiftly against scams still in their infancy.

As suggested above, the threat to small investors does not begin and end with fraudulent investment schemes, since even legitimate investment programs made available by reputable securities firms may be opportunities for misconduct on the part of habitual violators of state securities laws and rules. A typical violation by a "bad broker" would involve making an investment recommendation clearly unsuitable for the purchaser, such as the elderly widow in need of steady income and preservation of capital who is convinced by a broker to move his or her life savings out of government-insured certificates of deposit and into high-risk penny stocks. To head off such abuses, state securities agencies carefully scrutinize the track record of individuals seeking licenses to do business in their states. The guiding principle of state securities regulation is simple: If fraud and abusive sales practices can be isolated and stopped before reaching small investors, there is a compelling public interest in doing so.

The "preventive medicine" philosophy of state securities regulation dates back more than two decades before the creation of the SEC. The first modern "blue sky" securities law was adopted in 1911 by the state of Kansas. The term "blue sky" refers to speculative schemes that, in the words of a judge of that period, had no more substance than a "square foot of Kansas blue sky." The Kansas law served as the model for state registration of securities offerings and also required the licensing of broker-dealers and their agents. The shared system of state and federal regulation of the securities markets in the United States began more than two decades later in 1934, when the SEC came into existence.

A pillar of NASAA's efforts to protect individual investors is an aggressive and innovative investor education program. The Association unveiled a toll-free investor hotline three weeks after the 1987 "Black Monday" stock market crash. More than 15,000 individuals were assisted during the first six months of the Hotline's operation. NASAA also has undertaken an aggressive program to get the word out to consumers that, prior to turning over their money, they should do their homework. The first step: contact the state securities agency where extensive background information on investment salespersons and firms is maintained. State securities agencies also will let consumers know whether a particular investment opportunity is properly registered. On the national level, NASAA has joined forces with organizations representing the elderly and with other consumer advocates to help them in their efforts to educate their members about the services provided by state securities agencies. On the state level, individual NASAA members have undertaken equally aggressive investor education efforts and have teamed up with local organizations to get the word out about smart investing.

The Association also educates financial services consumers through a range of publications. NASAA periodically issues the "NASAA Investor Bulletin," with recent editions focusing on Persian Gulf investment scams and "affinity fraud" targeting members of specific ethnic, religious, professional and other groups. NASAA also works with the Council of Better Business Bureaus on the "Investor Alert" project, a quarterly publication intended to alert the investing public to new and widespread investment frauds and other schemes. In conjunction with this hearing, NASAA is releasing an Investor Bulletin, "How Older Americans Can Avoid Investment Fraud and Abuse," which will be distributed to the news media and to organizations representing older Americans. This document also will be available to anyone requesting it from NASAA or from any of the 50 state securities agencies.

### *POTENTIAL NEW PROBLEM AREAS*

Mr. Chairman, Senator Cohen, and Members of the Committee, as this nation's financial markets continue to evolve, new investment-related problems will emerge. Today, we are faced with two such issues which warrant the attention of the U.S. Congress and state and federal regulators. These two issues are: (1) the entry of banks into the securities arena, and (2) changes in pension and tax laws. Both of these developments likely will have a disproportionate impact on the finances of older Americans.

The Entry of Banks into the Securities Business

By the banking industry's own admission, it is the financially unsophisticated consumers who are being targeted in its increasingly intensive marketing of securities-related products. The Market Facts research firm in 1988 released a study that concluded that ***"banks will succeed in the sale of nontraditional banking products only by focusing on unsophisticated buyers, often first time investors."***[4] The study said that, as much as banks would like to capture the glamorous, upscale market, they are not likely to woo many rich or sophisticated investors away from their brokers, "who provide true 'full service,' including friendship, Christmas presents, and golfing invitations." Instead, the report advised that in order to make a significant impact on the bottom line, bankers would have to go after the bread-and-butter customers, the "ones who are confused and a little distrustful of financial products".[5]

There is a real and demonstrated risk of public confusion when uninsured products are offered inside the four walls of a bank. The promotion of American Continental Corporation (ACC) bonds through the high-pressure sales arm of Charles Keating's Lincoln Savings operation clearly illustrated how unsophisticated consumers easily can be led to believe that an uninsured product is somehow "guaranteed" by the bank in which it is sold. A lengthy investigation into the Lincoln Savings and Loan collapse by the California Department of Corporations, which involved more than 100 ACC bondholders and Lincoln salespersons, painted a chilling picture of overreaching and abuse of investors. On March 2, 1990, California filed investment fraud charges against Keating, ACC and two of its top officers and directors. In the action, the Department alleged massive fraud schemes in which investors were manipulated or misled through a combination of tactics, including[6]:

- ***The purchasers, many of whom were elderly, disabled and on fixed incomes, were not informed that the ACC bonds were uninsured*** An elderly, Glendale, California woman, who invested $10,000 through Lincoln Savings, told Department investigators: "While opening a new account at the new account desk we were advised by the person at that desk that we should invest at least a third of our funds into bonds ... It was my understanding that the bonds, or debentures, that we were purchasing were Lincoln bonds. The teller told us that the bonds were just as good as government bonds, that they were very safe and they were backed by Lincoln. Neither Lincoln, nor the teller, nor ACC informed us, before we invested, that these bonds were not federally insured. Had we known that these bonds were not insured by the federal government we would never have purchased this particular bond ... My husband is 84 years old and has had a stroke. I am 80 years old. Our earning days are over."

- ***Many of the ACC investors were specifically misled in being told that the bonds were insured and risk free***. An elderly woman who invested more than $50,000 of her savings at the Burbank branch of Lincoln Savings told the Department that: "... a teller ... advised me that I should go talk to a person, who I believe was named Bob Moore, sitting at a separate desk within the Lincoln office. Behind the desk where Mr. Moore was sitting was a sign which read "**Insured by the FSLIC**." Moore told me that putting my money into this account was just like another savings account. He told me there was absolutely no risk and that these funds were backed by Lincoln ... I followed his advice and transferred $43,000 from my savings account into the 'account' he had recommended ... I have no idea what a 'subordinated debenture' is and to this day I still have no idea what that term represents".

Alarmingly, a Lincoln Savings salesperson told the Department that a deliberate effort was mounted to mislead customers about the high degree of risk involved in the ACC bonds. He said: "As a matter of general procedure, we never responded with a straight 'yes' or 'no' when asked whether the ACC bonds were federally insured. We were instructed to say that the bonds were backed by $7.1 billion in assets so there was no risk".[7]

High-pressure and deceptive tactics in the sale of securities products by financial institutions are not isolated to Lincoln Savings and Loan. In Cahokia, Illinois, 800 investors were allegedly deceived into buying $10 million of unsecured notes from Germania Federal Savings. Most of the investors were elderly and on fixed incomes. They were solicited through letters, newspaper ads and brochures in the thrift's lobbies. The money raised was to be used to shore up the failing thrift.

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[4] Lawrence A Darby, "To Market New Products, Target the Confused Buyer," American Banker, April 26, 1990, p. 4

[5] Ibid.

[6] For a detailed discussion of the action and examples cited, see, press release of the California Department of Corporations, "California Department of Corporations Seeks Stiff Civil and Criminal Action in Keating/ACC/Lincoln 'Campaign of Fraud and Deceit'", March 2, 1990

[7] Ibid

In one case, an elderly widow who had her entire life savings in Germania and was undergoing cancer treatments, received a call in the fall of 1987 from a salesman for Germania urging her to switch her money from certificates of deposit (CDs) to the subordinated notes, which he said the thrift was selling to its preferred customers. The notes paid 11 percent interest, just enough extra income, the woman calculated, to cover her medical bills. The woman alleged that she was told that the investment was not covered by federal insurance but that it was protected by the bank. The thrift representative reassured the widow, telling her that the bank had been around for 100 years and kept saying the investment would be safe. The widow agreed to put her available money in the subordinated notes. And then, each time one of her CDs would near maturity, the bank salesman would call her to switch the money, and she did. Why did the widow agree to pull her money out of the fail-safe CDs and put it in the riskier notes? **"If you can't trust a bank,"** she said, **"who can you trust?"**[8]

There is an abundance of evidence showing a demonstrated inability of many consumers to distinguish between what is and what is not covered by federal insurance when investing in an insured financial institution. The many examples make clear that small investors need more, not less, protection when it comes to securities products offered by insured depositories.

Changes in the ERISA Laws

Until recently, most wage-earning Americans depended upon social security payments coupled with payments from defined-benefit pension plans for their retirement. Defined-benefit plans are rapidly disappearing in favor of defined-contribution and self-directed 401(k) plans. Both require that the beneficiary make investment decisions which many, if not most, individuals are ill-equipped to make. More importantly, both arrangements require that the retired person decide how the proceeds of the plan are to be invested.

It is at precisely this time that older Americans are extremely vulnerable to fraudulent or incompetent advice. By the latest count, it is estimated that over 40 million American workers are covered by 401(k) and similar self-directed plans, and that an even greater number are covered by defined-contribution plans.[9]

## *CONCLUSION*

Mr. Chairman, Senator Cohen, and Members of the Committee, I want to again commend you for holding this hearing. In particular, NASAA wishes to express its appreciation to Mary Gerwin, Helen Albert and Greg Smith for the long hours and hard work they have expended in examining the issues involved in investment fraud and abuse aimed at the elderly. It is through a focused effort to educate older Americans about to avoid being victimized in an investment scam that we have our best chance for arresting the growth in the investment fraud business. The need to properly educate all Americans about wise investing was underscored in the findings of a national survey released last year.

That survey, conducted by Louis Harris and Associates, Inc. for the National Consumers League,[10] found that American adults are considerably more likely to have financial investments (54%) than they are to read the financial news on a regular basis (26%) or understand the language used to describe investment and financial matters (37%). The authors of the survey concluded: ***"This gap between having investments and having the knowledge of what might constitute a sound investment puts many Americans potentially at risk for victimization by investment fraud."***[11] NASAA is pleased to join the Members of this Committee in exploring new ways in which regulators and others may better protect older Americans from investment fraud and abuse, and how we may help older Americans avoid becoming the victim of an investment scam.

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[8] David Maraniss, "Illinois Case Reveals the Many Victims of an S&L Failure," Washington Post, September 23, 1990, p A1

[9] Ellen Schultz, "Wall Street Gets the Go-Ahead to Provide Advice For Investments in Employee Retirement Plans," Wall Street Journal, October 30, 1992, p C1

[10] Ron Bass, vice president, and Lois Hoeffler, research associate, Louis Harris and Associates, Inc., "Telephone-Based Fraud A Survey of the American Public," conducted for the National Consumers League, study no 924004, page 6

[11] Harris survey, p 6

The CHAIRMAN. Thank you very much.

Let me ask two or three questions, then I will yield to Senator Cohen. You heard the statements previously, you have been very patient sitting and listening this morning. You heard from Mrs. Pharr and Mr. Us. Are these typical of how people are losing today their investments? Or were these atypical?

Mr. GUTHARY. Well, I think they're very typical. And in a sense, they are typical of two situations—one investor victimized by someone who appears to be just basically a liar, and in a sense a version of a scam artist, still working under a license, but probably working totally outside the law. The other one the victim someone that I think arguably was working within the law, at least on the surface, but developed a specific strategy to basically take advantage of the vulnerability of their targeted audiences.

The CHAIRMAN. Are the two salespersons that we've talked about this morning, that took these investments from Mr. Us and Mrs. Pharr, in some sort of a computer bank somewhere? Could a potential investor dial a particular 1–800 number, for example, and say is this gentleman or this gentleman, is he a problem broker, is he a problem investment advisor?

Mr. DIAMOND. There is what's called the Central Registration Depository, which all the States and the National Association of Securities Dealers use for licensing purposes. That's basically a computer data bank as well, and it has all of what we call the disciplinary histories of licensed sales representatives. I believe most States, and maybe all, will make that information available upon request.

The CHAIRMAN. Can someone hang out a shingle and on that shingle or on their card or on their stationery or in the yellow pages list themselves as "financial advisor" and practice without a license? Is this practice State regulated, or federally regulated?

Mr. GUTHARY. It's both federally and State regulated. However, there is no prohibition on using titles in most States or at the Federal level. There is only about a handful of States that actually regulate the use of a title. Most States and the Federal Government do not. They look to only your activity to determine whether you have to register as an investment advisor, not what you call yourself.

The CHAIRMAN. Could one say they are a financial advisor, and then could they go further and say that they are licensed as a financial advisor if they are actually not even required to have a license, could they go that far without being punished in some way?

Mr. GUTHARY. I think that would be fraud. But you have to remember, all you have to do to be licensed as an investment advisor at the Federal level is pay out $150 one time and abide by the so-called brochure rule.

The CHAIRMAN. Senator Cohen and I now are wrestling with what we can do as a government, as a Federal Government, to not only cooperate with you in the roles that you perform but also what we might do to strengthen Federal law. Is the Federal law that is pending now, the bill, the legislation pending now that you made reference to, Mr. Guthary, is that something that would tighten up the licensing requirements or not? I'm not familiar with the bill.

Mr. GUTHARY. The Federal Government, unlike the State governments, has no competency requirements to be an investment advisor. And the pending legislation does not change that. But what it does include is substantially greater registration fees, which would pay for a significantly enhanced audit program. Right now the Federal Government is on a 30-year audit cycle, which means if you are an investment advisor, you could easily go through your entire career and not be audited. So it's going to basically step up the auditing to make sure that registered investment advisors are providing services in the way they are supposed to under the act.

The CHAIRMAN. Do a lot of these so-called scam artists out there, do they wait until a person actually retires, or do they begin working on that person before retirement, knowing that there is going to be a potential nest egg out there, say at the magic age of 65 or what have you?

Mr. MCDONALD. Let me speak to the fraud issue a little bit. It's amazing the things you can do now with targeted advertising and targeted media effort.

We mentioned the infomercial problem. You can watch cable television in Los Angeles and see programs that are specifically targeted for the elderly community all day. If I had an investigator to sit and watch cable television all day, I could probably open a half dozen cases a day for unregistered offerings, unlicensed activity, and much of it is targeted for the very people we have been talking about today, people with a nest egg, people who are on a fixed income. Because the pitch is always geared toward that.

And a lot of these people call themselves investment broker or financial advisor. They use a whole variety of different terms. And the public is substantially misled by those terms into thinking that there is some regulatory oversight when there may or may not be.

Financial planner is not a licensed activity. We have seen estimates that there are as many as 200,000 to 400,000 people in the country who hold themselves out as financial planners. Eighty-five percent of their income is from the products they sell. And the public thinks when they go to those people that they are getting objective investment advice, when in fact there is every economic incentive for those financial planners to put people in the products on which they are getting a commission.

The CHAIRMAN. Recently I was watching CNN and there was an advertisement on the CNN station, and they gave a 1–800 number, it was relating to Social Security. So I dialed the number, and one of the first questions that I was asked when I finally got into the person answering the phones, they wanted to know my Social Security number.

Had I given them that Social Security number, no telling how many lists I would have gone on, no telling what kind of mail I would be getting. And I think a lot of people are very, very easy prey when they are asked to give out confidential information like that. I know many times they regret it after they have done it. But it's after the fact.

Mr. MCDONALD. An it's very slickly done. A lot of them have celebrity spokespeople, and it looks like a news kind of format, or looks like an interview format, when in fact it's just selling a prod-

uct. And when they ask you for your Social Security number, you don't think anything about it.

Mr. GUTHARY. Senator, also to your original question, I think one of the things that we noticed is the whole living will-type situation that's coming up has meant a lot of people now are very concerned with the decisions, and it's very common that people are being told they should have a living will to determine, in terms of incompetency, to make decisions.

We have now discovered that there are people writing these wills, and they get all the financial information on the individual and then they switch it over to a broker, some type of outfit that then has a complete financial profile on the person. They can then call up and they are very knowledgeable of the person's finances, of course. And these two people will look to be independent of one another because they have different names, and one often is a lawyer and the other one is a broker.

So in the sense of what you're saying, yes, I think there is, and they are kind of catching up with them. Although most of the fraud that we deal with, 5 years is a long time, they are a little bit greedier than that, so they are not quite that long range. But I think the answer would be yes, they are targeting them in a way of systematically going after their retirement money.

Senator COHEN. Thank you, Mr. Chairman.

Mr. Diamond, Mr. McDonald, Mr. Guthary, you draw a distinction between investment advisors, they're not licensed, financial planners, they're not licensed, and sales reps and brokers who are, correct?

Mr. GUTHARY. Investment advisors are licensed.

Senator COHEN. Investment advisors are licensed?

Mr. GUTHARY. Yes, at the Federal and State level. There are only six States, unfortunately Massachusetts being one of them, that don't license investment advisors. But the other 44 States do, and jurisdictions.

Senator COHEN. And under the same licensing process as a broker or a sales rep?

Mr. GUTHARY. Not quite. Half the States, like the Federal Government, only register the firm. So only the firm is licensed as an investment advisor. The employees do not have to be individually licensed. About 24 States actually have the same——

Senator COHEN. If I want to go out in Maine and hang out a shingle that says lawyer/investment advisor, do I have to take a test?

Mr. DIAMOND. You would, yes. In Maine, we have an investment advisor licensing requirement. We don't, as Barry Guthary points out, license somebody who works for an investment advisory firm. But we do require, as a condition of the firm's license, that all the people who are giving investment advice on behalf of the firm pass the series seven test as well as another test in State law. So we do at the State level in Maine require that you take examinations.

Senator COHEN. I was going to ask you the difference between a National Association of Securities Dealers series six versus the series seven test. It sounds like a BMW or Mercedes. But what's the difference between a series six and a series seven?

Mr. DIAMOND. If we called the series seven the Mercedes, I think I would tend to call the series six the old Chevy, which is one of my grievances. The series seven, I think, can be fairly characterized as a rather in-depth, comprehensive exam that attempts to give people a fairly substantial basis for understanding securities, although we have all seen people who somehow pass the exam and you say how, when you see what they have done.

The series six is a simplified exam, much shorter, much less in-depth, that focuses on mutual funds. And I think that the premise has been that mutual funds are rather benign investments and what can go wrong with mutual funds. And of course we now have a major case which shows that that premise is not accurate.

Senator COHEN. When we talk about salespersons as victims, I think you have used that phrase, they are not licensed but the firm they work for would be licensed?

Mr. DIAMOND. No, the salespersons would be licensed. Basically, in the parlance of the law, you have what we call a broker-dealer, which is the firm, the Merrill Lynch or the First Investors Corporation. Then you have what we call under State law the sales representative, or what are sometimes called under Federal law the registered representatives, which are the individuals who work for that firm, what people would commonly call stockbrokers. They both have to be licensed.

Senator COHEN. They both have to be licensed?

Mr. DIAMOND. Yes.

Senator COHEN. And you referred to these salespersons as victims?

Mr. DIAMOND. Well, I think what I was attempting to describe, really, was the same phenomenon that Mrs. Pharr pointed out, that in the First Investors case in Maine, and I think this is true nationwide, almost nobody was hired who had any background in the securities business. In fact, we once informally ran through the CRD computer system to look at the Maine licensees, and the most common prior employment we could find was with the Maine Turnpike Authority. I guess toll-taking gives you some financial background.

Basically, these people had no securities experience. So they only knew what they were taught. And they were pressured to make sales, and I think a lot of them did not know really what the problem was, any sooner than the victims did.

Senator COHEN. So license doesn't equate to knowledge, then?

Mr. DIAMOND. Well, I think that's one of the regrettable conclusions that one has to reach from that case. I don't want to be unfair and make the characterization too broad, but I think when it comes to the mutual fund area, I think that's an unmistakable message of the First Investors case.

Senator COHEN. You've also talked about the sort of schizophrenic conflict that's inherent in the broker-dealer relationship to a salesperson. The broker has a fiduciary obligation, does he not, or she?

Mr. DIAMOND. I think that would be a fair characterization. My colleague from Massachusetts is more the legal scholar than I, and he tells me that the problem with that notion is that people disagree as to what it really means these days to have fiduciary obli-

gation. But depending on how the relationship is set up, the traditional relationship would be pretty much a fiduciary one.

Senator COHEN. You call your broker, and say "I'd like some advice," and then he or she gives you that advice, saying "Buy such and such, XYZ stock." You assume that that broker is acting on your behalf?

Mr. DIAMOND. I think that's a very fair assumption, yes.

Senator COHEN. But there is also a monetary aspect to it, which you classify as sort of a schizophrenic conflict.

Mr. DIAMOND. Well, I think the method of compensation is somewhat problematic, because you only get paid if you make sales. So if you're conscientious and you spend 2 hours with somebody and you give them the most superb advice in the world and that's to do nothing, you get nothing. If you spend 15 minutes and you irresponsibly put them into a very high commission oil and gas deal, you may earn a pretty penny for your efforts.

So we have some built-in conflicts, but I think those may be to some degree unavoidable. I suppose all professions have that; I guess you can litigate unnecessarily and you can operate unnecessarily. But what seems to exist in the brokerage industry is an internal ethos, even among a lot of the major firms. That's why I used the example of a major wire house doing cold calling, where selling becomes so overwhelmingly the objective that it overrides really this basic ethical obligation that you have articulated, which is to do what's in your client's best interest.

Senator COHEN. What do you mean by a captive sales force, Mr. Diamond?

Mr. DIAMOND. Well, a captive sales force is when you have a company which creates its own investment products, mutual funds are a good example, and you may have a handful of them. It then has an affiliate, which is a brokerage firm. And its affiliate brokerage firm basically sells only its products.

Now, the notion that we just discussed is that the broker goes out there supposedly to make the recommendation which is in the client's best interest. He objectively evaluates the client's situation and the products and then makes a recommendation.

I submit to people that if all you have is a handful of proprietary products which you can sell, how conscientiously can you really fulfill that role? I have always been somewhat concerned with people who exist only to sell a rather limited number of proprietary products, because it seems inconsistent with this basic obligation that we have just discussed.

Senator COHEN. I have one other question for you, Mr. Diamond. In October 1990, you sent a letter to the SEC. I have a copy of that October 5th letter, which I would like to submit for the record, Mr. Chairman, in which you point out that merely providing or insisting upon a prospectus and a salesperson obtaining minimal licensing is not enough.

You outline the requirement for the disclosure of sales charges and commissions, for the actual value of the mutual fund at the date the monthly statement is issued, and a number of other recommendations, which I applaud you for. Is there anything you would change based upon your last 3 years of experience, that you would add to that letter?

H. Donald DeMatteis
*Superintendent*

Stephen L. Diamond
*Securities Administrator*

DEPARTMENT OF PROFESSIONAL AND FINANCIAL REGULATION
**BUREAU OF BANKING**
SECURITIES DIVISION
(207) 582-8760

October 5, 1990

Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Re: <u>Investment Company Release - File No. S7-11-90</u>

Dear Mr. Katz:

In responding to the Commission's request for comments on investment company regulation, it strikes me that the most helpful role I can play is to offer the perspective of a state regulator who for the past five years has spent considerable time personally handling the problems of small, unsophisticated investors. It is perhaps not surprising that from that perspective, the world of mutual fund investing looks very different from that which is described in your release. Thus, the focus of my letter is not on matters raised in the release, but rather on what I see as the major problem areas.

By way of further preface, I recognize that the remedies for some of the problems I raise may not be through amendments to the Investment Company Act or through action by the Division of Investment Management. All of the problems, however, fall within the Commission's regulatory ambit, as well as within the release's invitation to comment on "any other topics or issues relating to investment company regulation."

I. Sale of Junk-Bond Funds

There is little doubt in my mind that the major mutual fund problem in Maine during the past five years has been the aggressive

marketing of junk-bond mutual funds with little or no concern for the investor's level of understanding or ability to bear risk. While hard data are not available, I am confident in saying that one company alone has sold these funds to at least 4,000 Maine investors. Furthermore, there is good reason to believe that many of these investors were not in a position to bear, and did not understand, the risks associated with their investments.

It may be tempting to dismiss this problem as one which will disappear as a result of the dramatic drop in the junk-bond market. That view confuses the symptoms with the disease. Notwithstanding the high ethical standards of most participants in this industry, mutual funds are an attractive vehicle for those seeking to create overly simplistic marketing programs in which inexperienced investors are sold fund shares over the kitchen table by almost equally inexperienced sellers in whom they place complete trust. The type of fund may change, but the sales techniques, along with the resulting harms, are likely to stay the same.

It may also be tempting to dismiss this problem as one involving garden variety suitability and sales practice abuses for which adequate enforcement remedies already exist. If one takes the position that this is merely an enforcement matter, then a thorough inquiry into investment company regulation requires consideration of whether there are sufficient resources to police these abuses. To date, the record would suggest a negative answer. Given the labor intensive nature of this type of regulation, moreover, the situation is not likely to improve, particularly as the Commission focuses more on the international marketplace, while at the same time some of its members advocate diminishing the authority and resources of other regulatory agencies which might fill the gap.

Viewing this matter solely as an enforcement issue overlooks the historical commitment of securities regulation to the prevention, and not just the punishment, of abuses. From that perspective, the problem with the junk-bond funds strongly suggests that two of the principal safeguards for mutual fund investors provide less protection than promised. These safeguards are the requirement that mutual fund investors be given prospectuses and the requirement that mutual fund sellers pass a competency test as a prerequisite to licensing.

Discussions with Maine junk-bond fund purchasers lead to the conclusion that a large number never read the prospectus, but rather relied solely on the representations made by the salesperson. Furthermore, unsophisticated mutual fund investors

frequently complain that the prospectus is too complicated, and thus, the practice of ignoring that document is not likely to change. As a result, regulators must recognize that, however worthwhile for some investors, prospectus disclosure requirements, dealing with such matters as when and where in the prospectus the term "junk bond" must be used, are of no benefit to those who do not read, or cannot understand, prospectuses. In addition, when a mutual fund marketing program is targeted at the unsophisticated, one cannot count on an efficient market to compensate for the investor's limitations.

A curious aspect of the junk-bond situation is that many of the salespersons appear not to have really understood the risks associated with the investment, a phenomenon corroborated by the fact that sales were frequently made to friends and relatives. Almost all lacked prior securities experience, perhaps as a result of a deliberate hiring policy followed by their employer, and thus, their views were shaped by the training program of the firm selling the funds. The salient point is that notwithstanding their limited understanding of the product, the salespersons passed the NASD's Series 6 examination. This raises the specific question of whether one should be licensed to sell mutual funds without demonstrated expertise in the securities in which the funds invest. It raises the more general question of whether the requirements for obtaining a license to tell people how to invest their life savings are sufficient to ensure that salespersons are truly qualified to give such critical advice.

I would conclude this segment of my comments by apologizing for the fact that it is long on problems and short on solutions. I feel strongly, however, that the limitations of some of the current regulatory approaches cannot be ignored if investment company regulation is to afford meaningful protection to the small, unsophisticated investors for whom abusive practices often have the most devastating consequences.

## II. Periodic Payment Plans

For the reasons set forth in the Maine study of periodic payment plans, copies of which were forwarded to the Commission earlier this year, I believe a reconsideration of §27 of the Investment Company Act is in order. As you may recall, the study found an extremely low persistency rate for plans sold in Maine, resulting in extremely high sales charges for the many Maine investors who did not continue with their plans.

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Although our study was limited to the plans of one company, we have subsequently collected data from the other companies offering plans in Maine. While we have not published the results of this subsequent analysis, pending confirmation of our conclusions by the affected companies, I feel comfortable including in this letter our tentative finding for all periodic payment plans taken as a whole. Thus, the persistency rate for all periodic payment plans sold in Maine in 1986 was 49.6%. In other words, 50% of the plans were redeemed or effectively discontinued, and these planholders incurred sales charges ranging from approximately 15% to 51% of the amounts invested. This finding alone calls into question the effectiveness of the 1970 amendments to the Investment Company Act.

In my discussions with Commission staff members, it has been suggested that there may be too few participants in these plans for the Commission to devote time to the issue. While I have no idea what would constitute a critical mass, I would note that excluding plans redeemed under §27(f), there were 559 plans sold in Maine in 1986. Assuming similar sales in other states in proportion to their populations, the problem does not seem de minimis. Should the Commission conclude, however, that this issue is more appropriately addressed at the state level, as has been done in California and Wisconsin and to a lesser extent in Maine, it should keep in mind that a state's ability to limit or prohibit these plans is dependent on its authority to register investment company securities.

III. Disclosure of Sales Charges

Your release correctly identifies as warranting examination issues connected with the methods of financing the distribution of mutual fund shares. That sales charges are the subject of considerable investor confusion is not surprising in light of the multiplicity and complexity of the fees. Without offering any substantive suggestions, I think the Commission should place a high priority on investor comprehension in any actions it takes in this area.

I do have a specific proposal with respect to the disclosure of sales charges. I believe the Commission should reverse the no-action position taken by the staff in its letter of March 19, 1979 to the Investment Company Institute. That letter provided that enforcement action would not be recommended under Rule 10b-10 "if a customer's confirmation of a transaction in a security...issued by a registered open-end management investment company did not disclose the sales load...."

The staff's no-action position was expressly premised on the notion that disclosure on the confirmation was unnecessary because the prospectus would enable the customer to calculate the precise amount of the fees. Although logical on its face, this premise fails to consider the point made earlier, namely, that a significant number of investors do not read or cannot understand prospectuses. Furthermore, the actual amount paid by the investor is likely to be more meaningful than a generally applicable percentage figure. In any event, mutual fund investors who have come to see us with other problems have been surprised to discover, seemingly for the first time, the amount they paid in fees.[1]

The more difficult issue is determining what types of remuneration should be disclosed on the confirmation. At a minimum, the disclosure requirement should include the actual amount paid as a front-end sales load. Consideration might also be given to disclosing the existence of any 12b-1 fees or deferred sales loads, although obviously actual amounts (as opposed to percentage figures) would not be known.

IV. Disclosure of Current Value of Fund Shares

In our discussions with purchasers of junk-bond funds, we have been surprised to discover that, notwithstanding the receipt of monthly statements, many were not aware that their investments were declining in value. Indeed, a common complaint is that the sales representatives failed to advise them of their mounting losses. Further inquiries revealed that these investors did not know how to track the value of their shares.[2]

A simple solution would be to require that statements indicate the actual value of the mutual fund shares held by the investor as of the statement date. This appears to be an increasingly common practice and one which should not put an undue burden on investment companies.

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[1] Some companies appear to take affirmative steps to hide the sales charge. For example, I have seen mutual fund confirmations which include the sales charge on all of the copies except the one sent to the investor. On the investor's copy alone, the space for the sales charge is blacked out.

[2] As a partial remedy for this problem, the Maine Securities Division has published and widely disseminated within the State an introductory guide to mutual fund investing. That pamphlet contains advice on tracking the value of mutual fund shares.

Finally, I wish to commend the Commission for its review of investment company regulation and for opening the process up to outside comments. As more small investors turn to mutual funds as the means for participating in the securities markets, the goal of effective regulation takes on greater importance. A willingness to conduct a fair and objective review of the regulatory scheme should enable us to move toward that goal.

Sincerely,

Stephen L. Diamond

Stephen L. Diamond
Securities Administrator

SLD/ls

Mr. DIAMOND. I believe in all those points more strongly now than I did at the time, even. One of the problems we discovered with the First Investors case is that people didn't realize they had losses until the regulators called them. You could not tell from the statements what your funds or investments were worth. So they didn't know.

I think that the point I was trying to make in that letter, and it's one that I'm not sure everyone would agree with even among State regulators, is that there is a lot of trust in parts of this country. It's true in the State of Maine. People trust people. And what they invest in are not products, they invest in people. And so the prospectuses often do not help.

Regarding some of your questions to Mrs. Pharr as to what kinds of inquiries did you make, her answers are typical of what we receive, which is that "I trusted this person, I have confidence that this person was telling me the truth." And for these people who are the most vulnerable, and senior citizens are really a high percentage of them, all the prospectuses in the world are likely to be of limited or no value, because they are buying the person, they are not buying the investment. And unless we ensure that the people who are doing the selling are competent and honest, then we are going to have problems for as long as we have this kind of business.

Senator COHEN. Mr. Chairman, I have just one more question. Mr. Guthary, do you want to comment on that?

Mr. GUTHARY. Well, I also have just a point that I think should be made, and that is, from a court's point of view, Mrs. Pharr could not collect. The other thing about it is, if you go to a court, 99 out of 100 Federal judges now will claim that if you got the proper written disclosure, it was unreasonable for you to rely upon oral representations. They hold as a matter of law that it's unreasonable to rely upon oral representation, and this has happened over and over again.

So in a sense, I think what Mr. Diamond said, and sometimes we feel we are almost doing a disservice by making a prospectus be delivered, because it generally stops the person from collecting, even if they hear a bunch of lies from the broker.

Senator COHEN. What do you think about the SEC's proposal to eliminate the requirement that if you purchase a mutual fund from an advertisement in the paper that there is no written prospectus required? What does that do?

Mr. GUTHARY. That's a problematic proposal. Because I think it runs head in to two philosophies.

Senator COHEN. Yes, on the one hand you're saying, well, we provide you something in writing with no oral statements because you can't rely on oral statements, and now we say you don't need the statement in writing.

Mr. GUTHARY. And I think the SEC shows the schizophrenia there in that Federal securities laws and State securities are based on full disclosure. They have been for 50 years and we try to make more and more be disclosed. We have now discovered that we produce a document that the average person can't understand, probably doesn't read, and what do we now start doing? Oh, let's go to less and less and less.

I think we're going to have to figure this one out. I'm not sure that proposal doesn't have that problem. So I wouldn't say yes or no at this moment. But we have discovered we're going in two different directions at once here. And I think we really need to look at the laws and really figure out what we're doing. And I think the so-called plain English disclosure may be one way to go.

Senator COHEN. I wasn't aware, Mr. Chairman, that you had the same rules that pertain to a securities document as you would on a real estate transaction. The rule, as lawyers know, is that if you've got something, don't rely upon oral statements about real estate, because you are really bound by the document itself, and nothing said can change that written document. I was not aware that applied to a prospectus as well.

Mr. GUTHARY. There have been a few cases with unsophisticated people where they have held the oral counts. But most of the time, if the prospectus has accurate information, that's the end of the case.

Senator COHEN. Just one final question I want to ask you. Banks are not authorized to sell mutual funds, and I must tell you, I have some concerns that when a bank and a mutual fund share a common name, there is an assumption on the part of the investors that either the funds are guaranteed by the bank or the FDIC. I am worried that people are going to assume that somehow they have that kind of protection when the bank and the fund have that name.

Now, many banks post notices saying that this is not a guaranteed fund. My staff has been told that securities regulators have been going out into banks, and have found that those signs are behind potted plants. Mr. Chairman, they find those signs are now blocked from view by other obstructions, some other signs, and you can only expect that this will probably increase in the future.

Do you think that it is sufficient to have a disclosure posted like that?

Mr. GUTHARY. I'm very troubled by this, and it's something I think in Massachusetts we're looking into very intensely. I'm not sure, on one hand, generally the more people that are in a business the lower the cost. So having more people sell products in a sense should be a good thing. There is more competition. So in one sense, I don't want to necessarily have a knee-jerk reaction that that's bad because you're getting more people.

But I do agree that there is one, product confusion, two the signs, three, what I think from my experience is even more important, is that the banks do not have securities salesman culture. Even though we're critical today of some parts of the securities industry, they still have developed a culture that's far more disclosure oriented than banking or insurance. Neither one of those have built up over the years. You don't have to disclose anything in a bank. That isn't the way they work.

And I'm concerned that you're moving a product that's from one culture into another. And I think what you're taking is that from the banker's point of view, yes, the sign goes up, because they don't really think it's important. Because they have never had to tell anyone it's insured before, it's been insured since the 1930's, everyone assumes it. No banker tells you when you open an account that

it's insured, they assume you know it. They have the little signs at the doors and that's it.

And I'm not sure that they even think about it. And I don't think their training is very good at this point and so forth. So I don't know ultimately if it's a bad thing. But I think right at this point they are doing it too rapidly without a sufficient amount of training and understanding of the obligations they have.

Senator COHEN. I'd like to come back to your other point, the prior point that you made about the schizophrenic attitude of whether or not we have more disclosure in a prospectus and then you're bound by that, but then people aren't reading it because it's too complicated. It reminds me of how we've gone through many other aspects on disclosure in advertising, or warnings on labels. When I was at the local level as a city counselor, we had what they called visual pollution. We had more signs at an intersection, such as traffic signs and directions, that it became so complicated that it was totally confusing and people ignored it entirely.

So now you have the question, do you simplify it by having one sign or just a couple of signs? It runs contrary to the notion that greater disclosure means more information. We're getting information overload, and as a result of that, people are simply not reading any of it, and relying upon the sales person. So we've got a lot of self-analysis to make in a variety of areas, including the requirement of Federal warnings labels on various products. The more we put on, it seems, the less people are reading them unless they are in bolder and bolder print. And of course, as they get in bolder print, you don't have any room for the label itself, which presents a problem for us.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Cohen.

We're very indebted to you, these three witnesses, we appreciate your coming today and sharing your wealth of knowledge with the Committee. We hope that we can take that knowledge and turn it into something very constructive. We appreciate very much your attendance.

We're going to call our third panel. Mary Calhoun is President of the Calhoun Consulting Group. She is a consultant and expert witness in securities cases. We welcome Mary Calhoun.

Paul Westbrook is President of Westbrook Financial Advisers, Inc., New Jersey. He is a certified financial planner working with retirees and those nearing retirement.

Mr. Lester Kaplan is Executive Director of the Jewish Community Center of Greater Washington, and he is also a consultant on senior adult services.

We welcome all of you, and Ms. Calhoun, we will call upon you first. Thank you very much.

## STATEMENT OF MS. MARY E. CALHOUN, PRESIDENT, CALHOUN CONSULTING GROUP, INC.

Ms. CALHOUN. Thank you, Mr. Chairman, and Senator Cohen, members of the Committee.

I'm a consultant in securities arbitration and litigation. My firm has been retained in over 280 disputes between investors and their stockbrokers or financial planners. And I testified as an expert wit-

ness in 52 of these cases. I also serve as an arbitrator for the NASD and the American Arbitration Association. In 1987, I wrote a book called The Guide to Investor Protection, and I have been speaking out about investor protection ever since.

In the last 8 or 9 years, I have had a unique opportunity to observe investors and their brokers and financial planners and the disputes that separate them. The important thing to understand that I think has already been mentioned this morning is that senior citizens are victimized, not just by penny stock scams and commodity bucket shop operations, but also by elegant, Main Street and Wall Street brokerage firms and major insurance companies, including some of the ones who advertise about how solid and trustworthy they are.

Fees and commissions on securities sold to senior citizens are big business. Virtually dozens of investors, most of them senior citizens, have told me how they walked into a broker's or financial planner's office with their life savings and walked out with their nest egg invested in limited partnerships. The problem security of the future, the one that's being sold today, is collateralized mortgage obligations, CMOs. It's a type of security that pays a high commission to the advisor who sells it, and we're going to be hearing about it in the years to come.

So what can we do about it? First, I do believe that we can leave the commodities scam, the bucket shops, and the Ponzi schemes to the States attorneys general and securities divisions. Second, for the rest, we can do most of what needs to be done without new laws. It can be done by helping firms that sell securities understanding that better sales practices are better business. There are lots of examples of what could be done, here's one.

Margin and option agreements are a typical instrument of abuse. They should be printed in 12-point type, large enough for the average investor, let alone the average senior citizen to read. It's not only good sales practice, it's good defensive practice in preventing against frivolous complaints.

We can help the SEC and other regulators understand that they can use their enforcement leverage to encourage those good sales practices. In an enforcement action involving the abuse of margin and options, for example, a commitment for a large print account agreement could be a term of settlement. I was very impressed by Mr. Diamond's expression of creative use of his regulatory power in establishing a mandatory training program, his 45-minute morality play for newly licensed brokers.

With regard to the good sales practices, all it takes is one little note in Modern Maturity that a certain brokerage firm or a certain brokerage office has started making account agreements in large print. It sure beats censures, fines, and suspensions as a marketing tool.

Number three, you can help the regulators and the industry understand that good disclosure is good business. The SEC and State regulators need to continue to rethink the concept of disclosure. As Mr. Guthary indicated, investors don't need another thousand pages of prospectus, they need simple language, large print, plain English disclosure or risk and sales charges right on the front page of a prospectus.

Number four, education. If the SEC, the States securities divisions, or the Senate Special Committee on Aging were to hold a seminar on safe investing, you could not find an auditorium large enough to hold the crowd. Now, here's an example of how truly naive I am about how these things get done. Why not see if we could make the first page of the IRS Form 1040 mailing be a page, a little mini-textbook on safe investing?

You can encourage efforts by the SEC, SICA, which is the Securities Industry Conference on Arbitration, and the self-regulatory organizations to make arbitration easier for pro se claimants. Arbitration works. It's fast, it's cheap and it's fair. But we do need to look more closely at how pro se claimants are faring.

Five, your appointments. You can encourage the appointment to the SEC and the CFTC of individuals who understand that good sales practices and good disclosure are good business, and who can be creative and bold enough to work with the industry and investors.

Finally, in terms of legislation, three primary areas you must be watchful for. Number one is private right of action, investors must retain or where they do not have it must gain the right to recover life savings lost because of abuse by the financial advisors. Second, attorneys fees. Without awards of their attorneys fees, defrauded investors cannot be made whole.

Thirdly, statutes of limitation. Under Lampf, Pleva, 3 and 1 year statutes of limitation or repose are simply not consistent with the way that senior citizens are victimized and with the way they can reasonably be expected to react. With limited partnerships, for example, problems may not be discovered for many years after the purchase of a security. Moreover, by the time the senior finishes the process of complaint, and they all begin with SEC, then they get shuttled over to the NASD, then they finally end up with the States. Then if they haven't given up, they end up with an attorney who tells them that their claim is time-barred and they no longer have a 10(b)(5) action.

If you believe that investors should have protection under the Federal securities laws, you must be mindful of the need to protect their right to complain in timely manner that's consistent with the way their complaints are likely to be made and with the securities purchases.

Finally, I suggest that there be a part two to this hearing, in which you invite representatives from brokerage firms, insurance companies, the securities industry associations, the New York Stock Exchange, NASD and individual brokers and financial planners, to ask "What are you going to do about it?" Don't forget to ask them about large print margin and option agreements.

I look forward to observing the benefits of these changes for financial professionals, the securities industry, and current and future senior citizens.

[The prepared statement of Ms. Calhoun follows:]

CALHOUN CONSULTING GROUP, INC

MARY E. CALHOUN
*President*

9 Galen Street
Watertown, MA 02172
617-924-1522
Fax 617-924-0919

May 25, 1993

**Testimony of** **Mary E. Calhoun, President**
**Calhoun Consulting Group, Inc.**

**Before the** **United States Senate**
**Special Committee on Aging**

**Hearing topic: "How Secure Is Your Retirement: Investments, Planning, and Fraud?"**

Chairman Pryor and members of the Committee, my name is Mary Calhoun. I am a consultant in securities arbitration and litigation. Our firm has been retained in over 280 disputes between investors and their financial planners and stockbrokers, and I have testified as an expert witness in 52 of these cases. I also serve as an arbitrator for the National Association of Securities Dealers and the American Arbitration Association.

In 1987, my book The Guide to Investor Protection was published. In writing on the subject of investor protection, I have drawn on my experience as a former stockbroker, and on dozens of interviews I have conducted with regulators, investors, attorneys, stockbrokers, financial planners, and their supervisors. I've had a unique opportunity to observe the relationships between investors and their financial planners and stockbrokers, and to observe the disputes that separate them.

## I. Why are senior citizens vulnerable to financial fraud and abuse?

### A. The common denominator

There is a common denominator in investors' disputes with their stockbrokers and financial planners, and there is a typical victim: the common denominator is a lump sum of money in the hands of someone who has no experience in managing money.

The typical victim is a senior citizen, possibly a widow who inherits money upon her husband's death, a retired couple who have received a lump-sum distribution from their pension plan, or a senior who has made the painful decision to sell his family home and move to senior housing.

Today, there's a new victim: the senior who can no longer comfortably survive on the 2.7% yield available on their bank CD's. The correct recommendation for these investors is a combination of prudent investing that can boost their yield to 4-5% without taking on undue risk, plus a dose of old-fashioned advice that it's time to tighten their belt. Unfortunately, however, some naive investors are easy pickings for the unscrupulous broker or planner who will tell them how easy it will be for them to get 6-10% income without telling them of the quantum leap they'll also have to take in risk to both their principal and their future income if they want to try to get those returns.

**B. Why problems occur**

Of course, many senior citizens enjoy long relationships of trust with their stockbrokers and financial planners.

Unfortunately, however, many are or will be victimized, and for good reason: the more complex and risky an investment, the higher the commission paid to the adviser who sells it.

The result is a temptation for advisers to recommend an investment that pays a higher commission rather than one that offers the greatest benefit to the investor.

In 1987, I developed the pyramid attached to this statement. It's called the "**Pyramid of Temptation,**" and has been reprinted in The Wall Street Journal, Sylvia Porter's Personal Finance, Consumer Digest, and numerous other financial publications. The copy attached to this statement is reprinted from The Boston Globe.

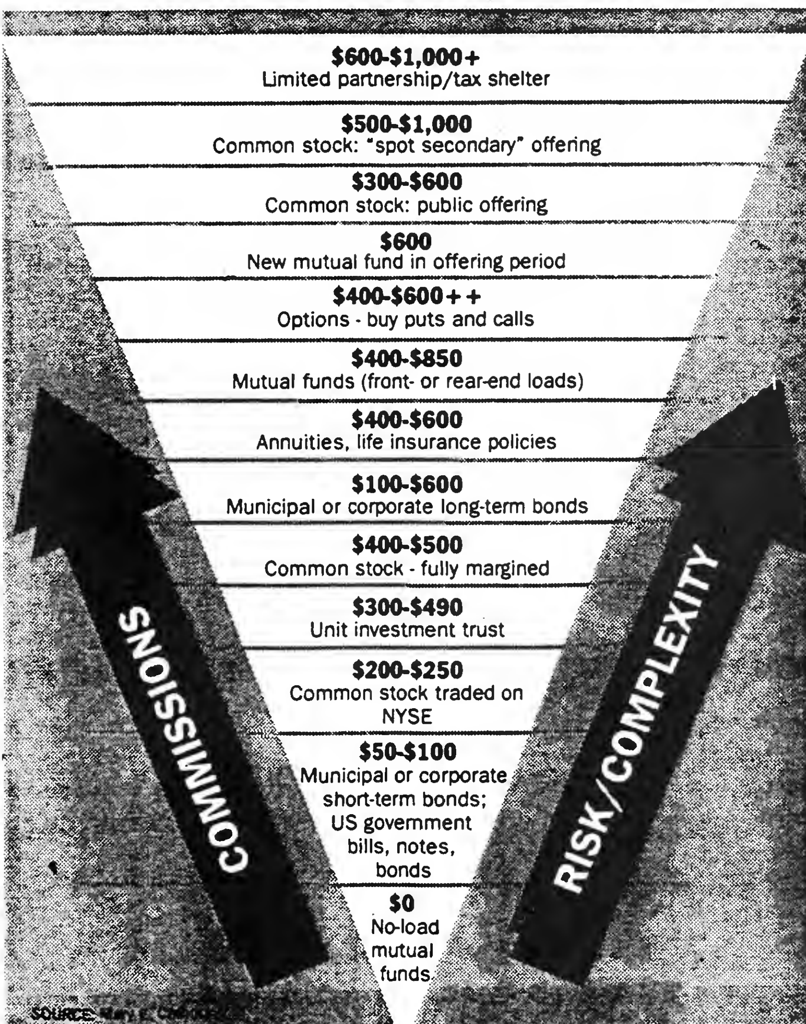
The pyramid shows that the greater the risk and complexity of an investment, the greater the commission paid to the adviser who sells it. These high commissions provide an adviser an incentive to recommend the riskiest products--including "packaged" products like limited partnerships, special offerings of brand-new securities, or the problem security of the future--collateralized mortgage obligations ("CMO's")--rather than old-fashioned, conservative, simple investments like plain old common stock and ordinary municipal bonds.

THE BOSTON GLOBE • THURSDAY, OCTOBER 11, 1990

# Money

## Your stockbroker's "Pyramid of Temptation"

The commission your financial adviser earns when you invest $10,000




GLOBE STAFF CHART

In a nutshell, this is why so many seniors have been victimized. Virtually dozens of investors, most of them senior citizens, have told me that they walked into a financial planner's office, cashed in their CD's, and walked out with their entire life savings invested in limited partnerships. Today, they may be exchanging their nest eggs for CMO's--collateralized mortgage obligations.

Most investors, including the vast majority of senior citizens, don't understand these complex investments. How can they? Two months ago, Salomon Inc. announced that they had lost $250 million trading mortgage-backed securities. Published estimates say that J.P. Morgan & Co. has lost $100 million trading these securities.

Yet these securities are being sold to individual investors. If Salomon and J.P. Morgan don't understand how to prevent loss in CMO's, how on earth can the average investor?

**C. Why problems are difficult to solve**

**1. Senior citizens see the SEC as their personal "911" for securities freud**

Back in the 1930's, Franklin D. Roosevelt, Joseph P. Kennedy, and William O. Douglas made it clear to the American people that the purpose of the newly-enacted securities laws was to protect <u>them</u>. Rightly or wrongly, that is how senior citizens still see the SEC: as their one-on-one protector in time of trouble with their financial advisers.

We, however, know how difficult it is for the SEC to protect these investors. Difficult, but not impossible, and I'm pleased to say that I have begun to work with the SEC to improve their communication with individual investors.

**2. Senior citizens may be overwhelmed by the difficulty of bringing a claim against their financial adviser**

**a. The "black holes"**

Many are victimized by commodities scams and "bucket shops," and Ponzi schemes still flourish. These problems are best addressed by State Attorneys General and Securities Divisions.

**b. Securities arbitration**

Securities arbitration works: it's inexpensive, it's fast, and it's fair. Although great strides have been made in recent years in making the forms less difficult for investors to complete, these gains have been offset by the trend toward making arbitration more like litigation, including complex issues of discovery, motion practice, including motions to vacate an award, and briefing--all of which are virtually impossible for the pro se claimant.

## II. What can be done?

### A. Help the industry understand that good sales practices are good business

Be creative: use your influence as you interact with the industry to encourage them to find ways to make good sales practices marketing tools. Help them understand, for example, that an idea such as publishing margin agreements--a typical instrument of abuse--in 12-point type with a heading that says "Margin and Borrowing Agreement" instead of the usual "Client Agreement" is not only good sales practice, it's a good defensive practice.

Help the SEC and other regulators understand that they can use their Enforcement leverage to encourage these good sales practices: in an Enforcement action involving the abuse of margin, for example, a commitment for a large-print margin agreement could be a term of settlement.

All it takes is one little note in Modern Maturity that a certain brokerage firm or brokerage office has started making account documents available in large print. It sure beats censures, fines, and suspensions as a marketing tool.

### B. Help the regulators and the industry understand that good disclosure is good business

In a recent talk before the North American Securities Administrators Association, I encouraged them to rethink the concept of disclosure, particularly with regard to the small business initiative.

Investors don't need another 1,000 pages of prospectus disclosure--they need simple common sense and plain English. All it takes is simple, straightforward disclosure of risk and sales charges right on the front page of a prospectus.

### C. Education

1. Encourage SEC efforts to improve communication with investors who contact them in time of need.

2. Encourage efforts to enhance disclosure of risk in investments--in a way that investors can understand.

3. Encourage efforts to enhance disclosure of advisers' past problems with self-regulatory organizations, the SEC, state regulators, and previous arbitration awards and civil and criminal actions.

4. Encourage efforts by the SEC, SICA (Securities Industry Conference on Arbitration), and the self-regulatory organizations to make arbitration easier for pro se claimants.

**D. Appointments**

Encourage the appointment to the SEC and CFTC of individuals who understand that good sales practices and good disclosure are good business, and who can be creative and bold enough to bring about changes that benefit both investors and the industry.

**E. Legislation**

**1. Private right of action**

The right to recover, in a court of law or in arbitration, life savings lost because their advisers recommended risky, complex, unsuitable investments is vital to protection of senior citizens. State statutes are not sufficient. Investors must keep this protection where it currently exists under Federal law, and must have it where it does not, as in proposed legislation regulating financial planners.

**2. Attorneys' fees and punitive damages**

Without awards of attorneys' fees and and punitive damages, investors often cannot be made whole. Arbitrators simply don't give away this type of relief without careful and just consideration of whether it is warranted. Their right to do so must be protected.

**3. Statutes of limitation**

Under Lampf, Pleva, a 3-year statute of repose and a 1-year statute of limitation are simply not consistent with the way senior citizens are victimized and with the way they can reasonably be expected to react.

Limited partnerships, in particular, are complex investments in which the discovery of misconduct on the part of the adviser may not occur for many years after the purchase of the security.

Moreover, by the time the senior completes the process of complaining to the SEC--which is where they all begin--then to the NASD, and then to the State, they may be exhausted and simply give up. If they still have the strength to contact an attorney and the attorney does not refuse the case because it is too small, the attorney may still refuse the case because a Rule 10b-5 claim is already time-barred.

A reasonable statute of repose for Federal securities claims is 3 years. A reasonable statute of limitation is 6 years.

**III. Summary of Recommendations**

Recently, there has been much negative publicity for brokerage firms and financial planners. Every time a bad broker is named in the financial press for recommending unsuitable options trading, or a planner absconds with client funds, the good guys lose potential clients.

The key is to manage change in such a way as to increase investors' confidence in financial advisers while showing the industry that better sales practices and disclosure will not only help to protect them from frivolous claims, but will help them market their services to senior citizens.

We must trust the investing public to use the increased information available to them wisely, and to continue to work with ethical brokers and financial planners who utilize good sales practices and full disclosure of risks, rewards, and compensation.

I look forward to observing the benefits of these changes for both financial professionals and current and future senior citizens.

The CHAIRMAN. We appreciate very much your attendance and giving us your wise counsel. We are grateful to you.

Senator COHEN. We consider this to a mini-seminar, and should we have a full seminar, you will be one of our primary participants.

Ms. CALHOUN. Thank you, I look forward to that.

The CHAIRMAN. We'll have some questions in just a moment. Mr. Paul Westbrook, thank you for being with us.

## STATEMENT OF PAUL WESTBROOK, PRESIDENT, WESTBROOK FINANCIAL ADVISORS, INC.

Mr. WESTBROOK. Mr. Chairman, Senator.

I am a fee-only financial planner, which means I don't actually sell investments or insurance, but we give a lot of advice on those subjects. And we also have many clients who are elderly, retired or approaching retirement. In fact, today's retiree is indeed vulnerable. I come across many retirees who depend on interest for part of their retirement income, and who are generally dismayed by lower interest rates, in some cases below 3 percent today.

They are vulnerable to those selling investments and insurance who might misrepresent more risky investments to these typically conservative investors. And it leads me to make three points. The first point is that there are several conservative strategies, to help retirees gain back some of this lost interest.

And perhaps one of the strategies considered fairly sophisticated as well as rather conservative is called staggered ladder of maturities. It can be done with CDs or with notes, Treasury notes. You buy the ladder from 2 to 7 or 2 to 10 years, and you increase the average interest you have. So when the current note comes due, you're not in anguish of what to do with that money, you simply buy long to keep the ladder intact.

You have to have some liquid money, in case you have an emergency, all this money is not tied up. But this strategy also can be used for CDs. You buy 1 to 5 year CDs and keep the ladder and you increase on average your income. You take the anguish off your decision in terms of the current CD coming due. High dividend paying utility stocks is another conservative strategy.

The second point I would make, which has been echoed here several times, is that this current situation of forcing retirees to take greater responsibility toward their own investments in my opinion is only the beginning. There are other trends in place that will shift this investment responsibility to the individual even more. And this is particularly true for those planning for retirement.

With pension plans out of favor, those defined benefit plans, and with likely pressure on the future Social Security benefit, the third leg of the traditional three-legged stool, the individual's own savings, need becomes more critical. Thus 401(k)s and IRAs will become those more important to the individual.

Our firm gives many investment seminars for corporate employees, and this first-hand experience tells me that employees even in corporations are generally uninformed of the capital markets, lack understanding of investment risks, and do not understand the rewards of taking prudent long-term risks, let alone being a good investment consumer, which is much what this discussion is all about.

A simple chart, the bar chart here, is just an illustration of the value of understanding prudent market risks. By having a higher component in the stock market, understanding the long term, could increase your investment risk two or possibly three times over your career. This is just 20 years. It could be significant in terms of your retirement security once you finally would retire.

The third and final point I would make may at first seem a little audacious for this Committee. But in my opinion, with trends already in place, we could see a significant change in the very existence of retirement itself. Low savings habits, less future pensions, coupled with a lack of investment knowledge, could place individuals in a position of not having enough retirement resources at all.

I can imagine that in the not too distant future many individuals may simply get to age 60 or thereabouts only then to realize that they do not have enough to retire on. And not only then, but will probably never have enough to retire on. They will be forced to consider the unthinkable, they may have to continue working perhaps as long as they live. The alternative at that time could be placing their investments into great jeopardy by buying into investments that indeed sound too good to be true, and lose most of it.

Hence, in my opinion, the future prospects for investment misrepresentation and fraud for retirees is not simply a current situation that will go away as soon as the economy picks up. And thus, this hearing is not only a timely topic for today, but a subject for tomorrow as well.

[The prepared statement of Mr. Westbrook follows:]

Prepared Statement:

There are two areas that I would like to elaborate on that I believe could be helpful to the Committee: investments and retirement planning, both of which I have considerable experience.

## Investments:

Most of the 80s were kind to conservative investors. After high inflation ended beginning in 1982, investors continued to get high returns from safe and insured CDs and money market accounts at banks. Individuals received 8% to 9% for most of the 80s. The most common investment choice in 401(k)s were GICs, again another safe, 'no brainer.' The conservative investor was earning 4% to 6% over inflation in these conservative investments. Historically this is highly unusual, with only 1% over inflation being what professionals normally expect.

Since the beginning of 1990, short-term interest rates, which drive these safe conservative investments, declined precipitously. As we know, the Federal Reserve has orchestrated this decline to stimulate the economy. Retirees who depended on this income got 'sticker shock' when they came to renew their CDs or who were invested in Money Market accounts at banks or at mutual funds.

Suddenly investors were scrambling how to recoup their income losses. This led to several actions, or inactions, on the part of investors. Some have moved their money into investments that are of high risk, such as the stock market, or annuities that are invested in the stock market. Some have continued to leave their money in these low interest rate investments, mostly because they do not know what else to do. Some, unfortunately have been preyed upon and have lost considerable amounts of money. The first panel at the Hearing illustrated people being victimized who have lost most of their retirement money.

To make up for this lost income, I have even heard that retirees have taken action that for them has been unusual. For the first time that I can recall, there is a growing number of retirees who have joined the underground economy. I have heard more and more stories of retired moms who are working for the local card shop off-the-books and dads doing household repairs for people off-the-books.

Thus, there are a number of ways that people, and especially retired people, have responded to this severe decline in current interest rates.

However, as I testified at the Hearing, there are several safe strategies that investors can utilize to regain some of their lost income. Not that an investor can get easy money that the 80s gave us, but one standard strategy known to professionals is called: Staggered ladder of maturities. Its simplicity makes it one of particular note. The method spreads money at different maturities and holds each to maturity. Income is increased because money is invested at longer maturities, and no loss of principal occurs because bonds or notes are held to maturity, when the full face value is returned. As a bond or note, or CD, is due then it is invested at the longer maturity to keep the ladder intact and continuing.

Another strategy can involve either high dividend paying stocks, like utilities, or bonds themselves. Both are controlled by the marketplace of interest rates. As interest rates go up, the market value of bonds, and similar investments, go down. In other words, there is an opposite movement. However, bond investors who want higher income generally experience that higher income even though the principal goes up or down. In other words the income can remain somewhat steady in light of fluctuating values. But because many conservative investors could focus too much on the principal fluctuations, it is a strategy that requires some thought before using it.

Behind this and other methods that the elderly could employ, however, requires a certain amount of knowledge of investments. The need for education was discussed at the Hearing. It is clear that people at all income levels, especially those at lower and moderate income levels, are not very knowledgeable about investments. Thus, this has been a situation where the elderly have been prey at minimum to misrepresentation.

Further, the elderly are those who grew up in the depression and WWII where there was a sense of trust in others. Thus, as soon as salespeople gain the confidence of elderly investors, the elderly are more likely to take their word and not question their motives.

Even in the best of circumstances, there is a natural tendency on the part of sellers of investments and insurance products to present only the positive attributes of what they are selling. Particularly common is to use selective time-frames to show favorable investment performance results. Thus, the true performance, risks and limitations of investments is up to investors to uncover themselves.

This would not be too bad a situation were it not for the fact that most investors are very bad consumers of investments. Investors do not know what questions to ask. They don't have the knowledge to compare one investment to another other than in very simplistic terms.

This situation results in consumers being sold investments, versus being proactive and buying investments. Investors do not know how to buy investments because they don't know enough about them.

Thus, offered are a couple of recommendations for investment education.

Investment education should center on two areas, in my opinion:

- Understanding stocks, bonds and money market investments and using them as the primary, or only investments. This is as opposed to more esoteric investments that should be considered mostly speculation, such as gold, options, and even most real estate investments, where more knowledge and sophistication is needed.
- Learning how to become a good investment consumer. My suggestion here is that consumer organizations should be encouraged to provide investment information and education. This should be as broad-based and as objective as possible. Organizations such as Senior Citizen centers and the AARP, to name two, could be very helpful here. Also individuals should avail themselves of their libraries where a host of information and educational materials reside.

## Retirement Planning:

Of all the areas of financial planning, retirement is the most complex. From determining how much will be needed to live comfortably, to how many years in terms of life expectancy should be planned for, to how to deal effectively with inflation.

How would someone go about planning for retirement? First, one might try to figure out how much pension will be received at a future date. Then, what will Social Security pay, and when? How much additional money can be saved between now and retirement? What are one's current expenses and what will they be at retirement? Once retired, how long should one plan for in retirement? What about health care coverage? And long-term care, and how to provide for it financially? Should one buy long-term care insurance, or should one impoverish oneself to be entitled to Medicaid? Inflation planning is also critical. And of course, how can money be invested wisely to make this all happen.

Calculating all this into a coherent plan for the low and moderate income person, much less for the higher income earner, is very difficult. There are some general rules of thumb, such as replacement ratios that can be helpful, but they are very general and have limitations.

Replacement ratios indicate the general level of retirement income needed to provide for a continuing standard of living compared to pre-retirement income. Because replacement ratios are primarily a first-year retirement snapshot, they don't help for inflation planning. Furthermore, replacement ratios use averages, which may not be too helpful to all people.

All of these limitations considered, replacement ratios for someone retiring at age 65 would be as follows:

| | Pre-Retirement Income | | | |
|---|---|---|---|---|
| | $20,000 | $35,000 | $50,000 | $75,000 |
| Single: | 67% | 66% | 62% | 54% |
| Married: | 72% | 66% | 64% | 64% |

Thus, married people earning $20,000 before-taxes would need on average 72% (the replacement ratio) of their income, or $14,400 before-taxes ($20,000 times .72 equals $14,400), to maintain their standard of living for the first year of retirement. Factored in are lower income tax rates and less expenses pertaining to work such as commuting and clothing.

The Present Value Lump Sum methodology is a more precise and sophisticated approach, but is not easily and quickly presented here. In sum, it calculates the mathematical present value lump sum of benefit and income streams at the point of retirement and compares this total resource lump sum to all expense streams calculated as a lump sum. It allows for a much more precise and individualized calculation.

This methodology has been adopted by the Retirement Needs Analysis Task Force I have been a member of within the IBCFP (International Board of Standards and Practices for Certified Financial Planners). This task force sets standards for the financial planning field. The IBCFP is the main standards body for financial planners in this country, the holders of the CFP (Certified Financial Planner) designation.

Accumulating Enough. Math aside, there is of course the overwhelming practical problem: How to accumulate the money necessary and the benefits necessary to reach the amount on which to retire comfortably?

Throughout one's work career, people appropriately select jobs primarily based on career opportunity and salary, rather than the package of benefits. Since employers could have widely differing benefits, people cannot predict at earlier ages what their final benefits will be at retirement. The one area that people can control is their own savings habits and utilizing as best they can those benefits that are presented to them at their employment, like 401(k)s and 403(b)s.

Employer Benefits. In looking at the employer-benefits landscape, however, I can not be too optimistic about the future. The number of pension plans (defined-benefit plans) is declining, while the number of savings 401(k) plans (defined-contribution plans) is increasing. To the untrained eye, this may not be much of a problem. However, for those of us who have studied this area know that it has been the combination of a pension plan plus a savings plan that has made possible the retirement dream to so many Americans.

Because of this shift towards only a savings plan, workers will shoulder much more of their retirement planning responsibility than before. Workers, who are just beginning to realize this new responsibility, are not very well equipped to deal with it. Even where this new responsibility is realized, the worker usually does not have the knowledge nor resources to deal with it effectively.

It is not a trivial digression, in my opinion, to explore why this shift from pensions to savings plans has occurred. In fact, I believe this shift was unintended by policy makers. The overt intention has been to make sure all workers have equal treatment in the coverage of these tax benefit plans, a noble objective. However these intentions have led to workers having less benefits than before, a contrary result. The culprit: constant and burdensome legislation and regulation have been largely responsible for this shift. Employers are simply walking away from these qualified plans because of the complex and burdensome rules, while still providing in another form some of all of the previous benefits to the higher paid executives.

I am a consultant to a number of organizations and have been told on several occasions by senior management that the more Congress burdens their organizations with providing qualified benefits, like more restrictions and paperwork, the more senior management losses interest in these qualified plans. The danger is that when top management loses interest, then there is less support for these benefit programs, resulting in less benefits for the workers themselves. A result Congress never intended.

In fact, employee benefits in my opinion has been the 'whipping boy' of Washington and other spheres. Perhaps one of the best examples of this is the Accounting profession's insistence to account for future retiree medical expenses. The result: cut backs in retiree medical expenses for most workers. Not only was this not the intended result, the accounting profession doesn't much care that this has been the result, which is lamentable in itself.

One last item as it concerns qualified plans. Perhaps one of the biggest mistakes, in my opinion, has been to have essentially one rule for pension and savings plans <u>regardless of the size</u> of the employer. That is, the large, medium and small three-person office all have essentially the same rules to follow.

This 'one shoe fits all' approach has not worked well for anyone. Primary concern has been with smaller plans, where there is perhaps a single entrepreneur or professional and typically a few office employees. Because this small business owner has control of the benefits package, Congress has tried to close every possible loophole for this owner.

But all employers, regardless of size, have had to meet these difficult, and mostly burdensome rules. The complexity and weight of these rules and regulations have become a hardship for not only the small business owner, but for all other size employer. The result is such that the whole qualified pension plan area is in great peril today.

Thus, I have seen that the product of these actions, while not the intended result, has in fact had a serious effect on retirement benefits for all workers, especially the average and lower paying employee.

<u>Investments</u>. Given this state of affairs, where are we? We have come to the point where the 401(k), along with 403(b)s, is, and will remain in the foreseeable future, the main employee retirement plan for workers. While there are many advantages to 401(k) plans, early vesting, portability, and loans, all popular with workers, 401(k)s will not provide a comfortable retirement all by themselves.

Further, this type of plan requires investment decisions by workers. But workers are generally not knowledgeable about investment choices, and in particular are not knowledgeable as to the risk/return trade offs that different investments offer. Thus, the long-term security of a worker's retirement rests in no small portion to their own ability to invest wisely in these plans. To their credit, many employers have seen the need to provide investment information and education on investments, especially as it pertains to their 401(k) plans.

Our own firm provides such education to corporate employees through such employer sponsored seminars. This first-hand experience of designing and conducting these information and educational seminars gives our firm a very good perspective of what employees do and do not know about investments. The answer unfortunately is that employees at all levels do not know a whole lot about investments.

<u>Other</u>. There are other questions that can be discussed here, but will only be mentioned briefly. How can we stimulate workers to save more, not only for their own retirement but in turn save more as a nation itself? What is the future of Social Security, and can it continue as a mainstay of retirement security as it has for so many years?

In terms of saving more, the loss of the IRA deduction severely dampened the interest in the IRA, everyperson's pension plan. Because it dampened it for many people it gets little publicity for the lower paid where its effectiveness is still powerful.

The subject of Social Security is indeed as much emotional as technical. Is it as secure as some would have us believe, or is it headed for significant change when the baby-boomers retire and the trust funds need to call in all and more of the money that is currently being spent? It seems to me that we as a country need to be honest with ourselves, and younger workers in particular, to explore the reality beyond the rhetoric. In my own field, many financial planners are even projecting zero Social Security benefits for their younger clients.

<u>The Concept of Retirement</u>. Finally, a discussion of retirement planning would not be complete, in my opinion, without a discussion of the broad concept of Retirement itself. In listening to policy makers for the past number a years, I have sensed a lack of confidence, a lack of a philosophic direction in which to plan specifics regarding retirement. Perhaps it may be time to revisit the very concept of retirement.

The new reality in the workplace with cutbacks, restructuring, layoffs and a general consensus of shorter work careers with one employer, has permanently changed our employment landscape. Workers will no longer be with one employer for their careers, the end of which will collect significant pensions. This has changed abruptly over the past 15 to 20 years. Adding this to the actual decrease in pensions (defined benefit plans) in this country, one's retirement security has changed significantly and permanently.

Further, research on the elderly has shown, and retirees are proving each day, that we can remain active physically and mentally much longer than previously expected. There has also been a lessening of age discrimination towards older workers by employers. Furthermore, more workers have seen the need to work beyond the traditional retirement age, either by economic or psychological need. Thus, we are seeing real change as regards to our older population. Instead of a period of inactivity and decline, the vast majority of older people are healthy and active, physically and mentally.

In this changed landscape, what is our nation's policy on retirement? Do we want to encourage it as in the past? Do we want to simply increase the age slightly, as has been done with Social Security starting with those turning age 62 by 1999? It seems to me that until we incorporate these new realities into our thinking, policy makers will be using an outdated model of retirement in which to make decisions.

As an example of how a updated retirement perspective could help in dealing with a current issue, take the case of the earnings test within Social Security. Should the earnings limits be raised significantly or even eliminated, as many retirees who want to work would hope? If the trends in place show that younger people will not be able to retire as soon as before, and if the limits would be lifted, then anyone who reaches age 62 would draw their benefits regardless if they are retired or not. This would tend to deplete the OAS trust fund more quickly than assumed and place a considerable burden on the whole financing of the Social Security system. If we believe yesterday's retirement model will still be in place, we will come to a very different conclusion.

<u>In Sum</u>. The area of retirement planning is not only highly complex for an individual to deal with, it is highly difficult for the policy maker in Washington and employer across the country.

Given these comments, I offer several recommendations.

<u>Legislation and other Congressional action concerning retirement planning</u> should center on several areas:

1. As benefits legislation is considered, have a Congressional oversight on the possible end-effect towards the average worker. Sort of an 'environmental check' on average workers, rather than just trying to limit benefits to owners and higher paid employees. This, in my opinion has resulted in a serious benefits erosion for all Americans, and will continue to do so without this oversight.

2. Consider simplifying and stratifying the whole area of pensions (defined-benefit plans). Simplification could result in employers again reconsidering this benefit for their workers, and stratifying the rules for different size employers could make this a manageable and meaningful area for all employers.

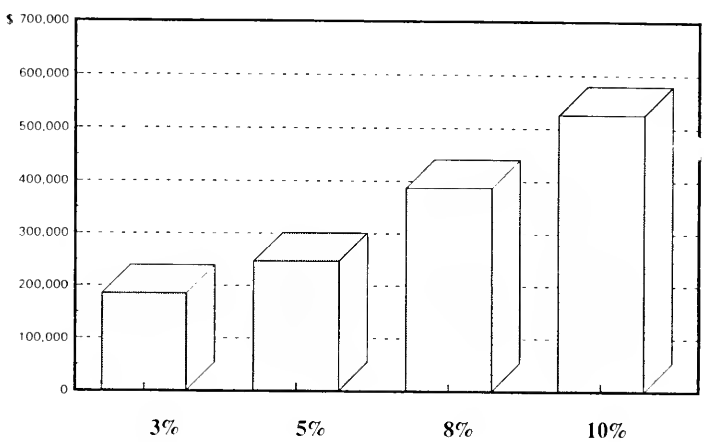
If some major action like this is not taken, in my opinion we may very well see pensions become essentially extinct in the not too distinct future.

3. Hold a comprehensive series of hearings on the whole subject of retirement. Corporate, academic, government officials along with individuals at different ages need to come together to help our country deal with the new realities and changes occurring in this area. This could provide specific future retirement scenarios given current legislation, demographics, and trends in our society. It could lead to a new coordinated effort between government and business.

4. Encourage employers and workers to increase their investment education about their 401(k) investment choices.

Paul Westbrook, CFP
President

# 20 Years of 401(k) Investment:




Assumes: Initial $50,000, $30,000 salary, 3% increases, 6% employee and 3% matching contributions.

The CHAIRMAN. Mr. Westbrook, thank you very much.
Mr. Lester Kaplan.

**STATEMENT OF LESTER I. KAPLAN, EXECUTIVE DIRECTOR, JEWISH COMMUNITY CENTER OF GREATER WASHINGTON**

Mr. KAPLAN. Good morning, Mr. Chairman, Senator Cohen.

The Jewish Community Center of Greater Washington serves about 80,000 people a month, approximately 10,000 of them are senior adults. They are a diverse group that clearly reflects a profile of the Nation's seniors. Many older people use the Center because it is located in what's frequently referred to as a NORC, an acronym for a Naturally Occurring Retirement Community.

The majority of those older people, regardless of race, religion, or national origin, make use of the Center facility, but it is the "old, old," those over 75 years, who attend specific programs designed for senior adults. This population is made up of moderate to low income individuals. I know many of them, and I am familiar with their difficult lives.

At our Center we see a steady decline in all areas where there is a fee for service for senior adults such as classes, travel and cultural events. Further, scholarships for senior adult Center memberships have increased by 30 percent in the last 1 year alone.

Older people seeking investment opportunities are frequently sold investments that have different degrees of risk without really understanding what they are purchasing. This is particularly significant for people over 75 years of age. If we consider the ramifications of that fact with regard to investing in the many different types of mutual funds, names that aren't even indicative of the kinds of funds, the funds' objectives, or even the funds' investments.

Investing in mutual funds can be an extremely confusing process, even for the sophisticated investor. But for a senior adult with no experience, terms like load and no-load, back-end load or front-end load, and 12(b)(1) fees, in addition to all the other terms, can be befuddling and frustrating. Additionally, older people do not have the time to recover money lost in a down market. Even testing the market can prove disastrous for those venturing in for the first time without knowledge and without life sustaining funds.

In 1985, for example, the private Maryland Deposit Insurance Fund Corporation failed, leaving thousands of senior adults, as well as other depositors, without access to their funds. Many of these senior adults had taken advantage of the higher interest rates offered by the Maryland fund-insured banks. Most were not even aware of the difference between Federal insurance and this private Maryland fund insurance.

The result was devastating. In the span of just 1 day, they were deprived of their interest as well as their principal. It was a horrible time, in which thousands of senior adults were subjected to an arduous process that inflicted pain and hardship on their fragile lives. And this was just one example of the repercussions that can occur when even a simple, basic fact is not fully understood.

Even knowledgeable and sophisticated investors run into problems and lose money. But for senior adults, especially those "old, old," the risk poses the most serious ramifications. Some of the

problems, especially for those over 75, are dealing with unscrupulous salespeople who prey on their vulnerability, gullibility, and their fears and most important desire to be independent people, and their longing for long term or any kind of relationship.

Endeavoring to understand a prospectus that challenges even the most astute investor, understanding terminology that includes acronyms of words like REITS and other complex terms, reading small print that not even the strongest trifocal lens can make clear, maintaining expectations that are simply unrealistic, differentiating between investments that are insured and those that are not insured. Specific legislation is needed to protect our oldest and most vulnerable segment of the population from unscrupulous salespeople, lack of knowledge, and their own mistakes and anxieties.

I suggest that regulations are needed that require that each prospectus be generated with large print and simple, easy to understand language. Additionally, a longer period of time to examine, without penalty, investment purchases.

I also think there should be an ombudsman who would intervene in any investment offered to individuals over the age of 75, and that an easy to use process be created for the adjudication of disputes. It's only with beginning measures such as these that we can enable older adults to maintain their independence and remain in their communities, thus preventing premature and unnecessary and costly institutionalization.

Thank you.

[The prepared statement of Mr. Kaplan follows:]

JEWISH COMMUNITY CENTER OF GREATER WASHINGTON

6125 Montrose Road • Rockville, Maryland 20852-4857 • (301) 881-0100 • (301) 881-0012 TDD



**Testimony**

**By**

**Lester I. Kaplan**

**Executive Director**

**Jewish Community Center of Greater Washington**

**Before the United States Senate Special Committee on Aging**

**May 25, 1993**

**I am Lester I. Kaplan, executive director of the Jewish Community Center of Greater Washington. I have held that position for the past 10 years. Prior to that, I was the director of a camping facility for 1500 elderly people and the director of a psychotherapy center. I also directed the Worcester Jewish Community Center in Massachusetts, the YM/YWHA of Greater Flushing and the Samuel Field YM/YWHA in New York City. I was a professor at the City University of New York, New York University School of Social Work, Yeshiva University, Adelphi University and Columbia University School of Social Work. I also have practiced psychotherapy and I am a consultant on senior adult services.**

The Jewish Community Center of Greater Washington has a membership of almost 16,000 people - 2,000 of whom are senior adults. Our senior adults are a diverse group that clearly reflects a profile of the nation's elderly. Many more elderly use the Center than are members. That is because the Center is located in what is frequently referred to by Maryland officials as a NORC - an acronym for a naturally occurring retirement community. Older people choose to live near the Center because of the numerous services and enrichment we provide.

In close proximity to the Center are two senior housing buildings. One is a HUD 236 and one was funded by the State of Maryland and Montgomery County.

The majority of the older people living in the community, regardless of race, religion or national origin, makes use of the Center facility, but it is the "old, old," those over 75 years, who attend specific programs designed for senior adults. This population is made up of moderate to low income individuals who are mostly female.

When I was quoted in the New York Times in August 1992, I stated that, "Senior adults view independence the way others view life itself." My quote was based on my personal experience with my own elderly relatives. That, coupled with my professional background, provides me with a view of what is clearly a bad situation that is likely to get worse.

Low interest rates have helped young people to buy houses, and businesses to borrow money, but it has hurt older people by cutting into their disposable income.

We have gone from double-digit interest rates during the 80's to approximately 3% today.

At our Center, we are constantly reminded of their lost income. We see a steady decline in all areas where there is a fee for service for senior adults such as classes, travel and cultural events. Further, scholarships for senior adult Center memberships have increased by 30% in the last one year alone.

Although the rate of inflation is presently approximately 3%, expenses for senior adults (especially in the area of health care) are rising sharply. Twelve percent of the U.S. population use 33% of our health resources since older people have multiple health problems. They also have high pharmacy expenses. We have succeeded in extending the life span of individuals but the result has been a generation with chronic health problems! Meeting those health care problems is costly, cutting into disposable income of older people.

Based on a recent Montgomery County Maryland study by the Commission on Aging, an older person needs a minimum of $11,000 annually to live modestly in the county. Much of that income was once provided by bank interest. Given today's low interest rates, this is no longer the case.

Older people have no way of decreasing their expenses unless they deprive themselves of necessities. Their rent, utilities, medi-gap insurance premiums, dental care, eye glasses and pharmacy expenses account for a large share of a senior adult expenses.

A 1988 Census Bureau study showed that 27% of the income of senior citizens comes from interest income, stocks, bonds and other investments. Seventeen percent comes from public and private pensions, with Social Security providing 39%. The study also showed 17% coming from employment. These figures dramatically point out that the largest share of income for older adults is derived from a combination of Social Security and, obviously, bank interest. To make up for lost interest income, many senior citizens are scrambling for higher-yield investments.

I am concerned that older people seeking investment opportunities will be sold investments that have great degrees of risk without really understanding what they are purchasing. This is particularly significant for people over 75 years old.

The May '93 Harvard Mental Health Letter, a publication of Harvard Medical School, states, "Loss of cognitive capacity is one of the most serious problems faced by the old-old. In the mid-1980s an Epidemiologic Catchment Area survey indicated that 6.8% of persons aged 75-84 and 15.8% of those 85 and older suffer from severe dementia. Other studies have shown a prevalence of dementia in the old-old ranging from 20% to 49%."

If we believe that this is true, then let us consider the ramifications of investing in mutual funds. To make money in a mutual fund requires that an investor remain in a fund through up and down markets. The investor can switch funds but often only in particular groups. It can be extremely confusing, even for the sophisticated investor, but for a senior adult with no experience, terms like load and no load, in addition to all the other terms, can be befuddling and frustrating. Additionally, older people do not have the time to recover money lost in a down market. Even testing the market can prove disastrous for those venturing in for the first time without knowledge.

In 1985 the private Maryland Deposit Insurance Fund Corporation failed, leaving thousands of senior adults as well as other investors without access to their funds. Many of those senior adults had taken advantage of the higher interest rates offered by the Maryland insured banks. Most of them were not aware of the difference between Federal insurance and Maryland insurance. The result was devastating for so many who counted on the higher yield. In the span of one day, they were not only deprived of their interest but principal as well as the higher yield. Suddenly they were without their financial resources.

My Center, which took a lead role as the advocate for older people, helped seniors get monthly access to their money based on expenses. This was a horrible time in which thousands of senior adults were subjected to an arduous process that inflicted pain and suffering in their fragile lives. This is but one example of the repercussions that can occur when even a simple basic fact is not fully understood.

Buying investments other than bank Certificates of Deposit is extremely complicated for a generation that used bank CD's as their only vehicle to produce income.

Even knowledgeable and sophisticated investors run into problems and lose money. But for senior adults, especially those old-old in their declining days, the risks pose the most serious ramifications. Some of the problems I foresee for seniors, especially for those over 70 are:

* Dealing with unscrupulous sales people who prey on their vulnerability, gullibility and desire to be independent.

* Endeavoring to understand a prospectus that challenges even the most astute investor.

* Understanding terminology that includes acronyms of words like "REITS," and other complex terms like junk, which cannot be found in some of the best dictionaries.

* Reading small print that not even the strongest trifocal lenses can make clear.

* Maintaining expectations that are simply unrealistic.

* Difficulty differentiating between instruments that are insured vs. those that are not insured.

I suggest that specific legislation is needed to protect our oldest and most vulnerable segment of the population from unscrupulous salespeople, lack of knowledge and their own anxieties. It is clear that there are a few simple measures that can be taken at the outset.

First, and foremost, regulations are needed that require that each prospectus be generated with large print and simple, easy-to-understand, language. Additionally, a longer period of time to examine, without penalty, investment purchases is essential. That would enable purchasers to change their minds and withdraw if they so choose.

I also think there should be an ombudsman who would intervene in any investment offered to individuals over the age of 75 and that a process be created to provide for the adjudication of disputes.

It is only with measures such as these that we can enable older adults to maintain their independence and remain in their communities. The obvious benefits are the prevention of premature and unnecessary very costly institutionalization.

It is clear that the work ahead is both challenging and potentially very rewarding.

The CHAIRMAN. Thank you very much, Mr. Kaplan.

Your group serves as sort of an advisor to a lot of seniors, I assume?

Mr. KAPLAN. Yes, we have a number of different senior adult groups, including one group which is called Seniors Organized for Change. And they are a unique political action group.

The CHAIRMAN. I know, but do seniors come, say, to the Center for advice on investment counseling? Do they do this?

Mr. KAPLAN. They come for advice, and very often we refer them. They come for many different reasons, also, such as feeding programs, wellness programs, and the sort.

The CHAIRMAN. Right. The average senior citizen out there, right on the brink, let's say, of retirement, where would that person likely get some good, sound advice today with regard to investments?

Mr. KAPLAN. From seminars which we provide at our Center, for example.

The CHAIRMAN. Let's say that down in Arkansas, we don't have a Center like yours. Where would our people back home in our State and in Maine go?

Mr. KAPLAN. There should be opportunities held in a variety of places where people can be helped to understand what it is they're getting into. It doesn't really matter where. Television shows could be conducted, community meetings. I think education is important. Investing is fraught with anxiety.

At the same time, many of them are on fixed incomes, and especially people who have a nest egg of $50,000, let's say, and then wind up receiving a 3-percent yield on that money. When you take Medigap insurance, the cost of pharmacological care, eyeglass care, rent, they wind up in a crisis mode. And what's next is a decrease in their food. And of course, statistics show that it's the senior adults in our country who are most prone to malnutrition and other illnesses.

The CHAIRMAN. Ms. Calhoun.

Ms. CALHOUN. I would like to comment on that, if I may. Because I see that these investors have a thirst for knowledge, and it is often filled by financial planners and brokerage firms offering seminars. In many cases it may be primarily educational in nature. But in other cases, it's simply a means of getting names and addresses of people to contact, of establishing a relationship to be used to peddle products.

The CHAIRMAN. I'll bet a lot of fraud that's perpetrated against the elderly is not reported, simply because of the amount of pride that so many of these people have, and are ashamed, almost, to report that they have been taken advantage of, that they have been duped by some fast-talking salesperson. I'll bet there is a lot of this, where we never know how much fraud actually is out there, just because of the pure pride that they have.

Mr. Westbrook, did you want to comment?

Mr. WESTBROOK. I just want to echo this whole thought of education. This is a whole generation that did come through the Depression, World War II, and really relied on the simplest of investments, called CDs. And in the 1980's, you could almost not have made a mistake with investments.

The stock market was up dramatically year by year on average. Bonds did very well, because interest rates came down. Money markets, the simplest of investments in CDs, were earning 8, 9, and 10 percent up until recently. You did not have to understand investments.

And I would echo these thoughts here, that because of this vast void of education, many people are trying to fill it by giving education with not always the best intentions. The expressed intention is "we're going to educate you about investments," but when you actually attend them, which I do from time to time, I find it's a very distorted sense of "education." It may not be just education, it may be really a form of selling.

Mr. KAPLAN. One of the motifs of growing old in our society is the general perception of loss, there is a loss of mobility, a loss of physical abilities, there is a loss of family and a loss of friends, and a loss of relationships. It makes the senior adult, especially the old-old, which is of course growing in number, most vulnerable to anything. And the television sales and the telephone calls make it extremely easy for people to prey on them. So education is very important, but some type of regulation, I'm certain that most salespeople are great and that most investment vehicles are fine, but there needs to be some way of insuring the fact that the most vulnerable in our society have some recourse.

The CHAIRMAN. Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman, and I thank the three witnesses of this final panel.

Just so there is not a misperception out there of those who may be watching—if they're still watching, I'm not sure we're still filming this particular hearing—it sounds like it's high income or the big rollers who put money away. One of the prior witnesses' written testimony talked about targeting the elderly because you can make thousands. So they've got thousands and some even millions.

We're really talking about people of very limited means in most instances, people who have nothing other than perhaps what little pension might have been accumulated during their 20 or 30 years plus of employment. So we're talking about middle- and low-income people for the most part. We shouldn't lose sight of that fact as we're going through this discussion.

I would like to come back to what Ms. Calhoun said and ask this question of the three witnesses. When she talked about big, bold print, disclosure on that front page, it reminded me of a cigarette package, maybe Camels or Lucky Strike or whatever it is, and the symbol of that particular product on the pack, and then on the side, it says "This product may be harmful to your health." Is this something we're going to have to do with some securities investments; have several things on it with a big, bold disclaimer that this product may be harmful to your financial health? Is that something that's realistic?

Ms. CALHOUN. If necessary. For example, on an initial public offering of common stock, there could be a title page that has, this happens to be one of the pages from Mr. Kaplan's prepared remarks, one can tell he deals with senior citizens. It's nice, big type and it's bold print.

And it could say very simply, "You have just bought shares in an initial public offering of common stock. In doing so, you have become an important part of the process of capital formation in the United States of America. However, you should know that these shares are high risk in nature, and your salesperson should not tell you anything to the contrary. You should also know that your salesperson is receiving a commission of whatever it is, 50 cents a share on this offering. If you have any questions or concerns, please contact the manager of the branch office of your brokerage firm."

Something like that, very simple. And that kind of disclosure is currently not present. And it won't scare away the valid investors. They are anxious. The speculators, the people who really want to buy these shares and understand the risks, they'll be happy to buy it. But it will send off the alarm for investors who might otherwise be vulnerable to misrepresentation.

Senator COHEN. How about the saleperson who comes along and you've got that disclosure on the front page, and according to the rule, they're bound by what's on the page and not what's said. But suppose a well-dressed, well-mannered, attractive salesperson who has befriended an individual, and the individual says "What about this disclosure here? It says this is high risk." The salesperson will say "Look, no problem, they all say that. They all say it, it's part of the game. And if you're going to invest in the market, of course there are risks. Don't be too concerned, I would not be too concerned about that, Mrs. Smith."

What happens then? Is Mrs. Smith bound by the disclosure, or does she have a cause of action, a right to recover, because of the salesperson's general diminution of the importance of that disclosure?

Ms. CALHOUN. In securities arbitration, which is where she will probably end up, her chances of recovery are excellent if she is, if her testimony is credible about what happened. Because arbitration panels do an outstanding job in determining who's telling the truth and how to dispense equity and justice.

Senator COHEN. Does that mean that those who complain, who go to arbitration, are not bound by the prospectus, but can in fact say that the salesperson either misled me, or that the oral representations take at least equal weight with the written prospectus? Is that the rule?

Ms. CALHOUN. Well, there's no rule. But arbitrators are empowered to dispense equity as they see fit. And so they are much more likely to take into account her lack of sophistication, and by listening to the testimony of both parties, determine which party is credible and to take that into account in rendering an award.

So in that scenario, they are actually more likely to receive a fair outcome than in court.

Senator COHEN. So if Mrs. Pharr had gone to arbitration as opposed to going to court, she would be much better off?

Ms. CALHOUN. Based on what I've heard, in my opinion, yes. Arbitration works. It works very well, and arbitrators do an excellent job of rendering justice.

Senator COHEN. But why should an arbitrator have greater power than a judge? In other words, why should an arbitrator be in a position to say "I believe you, Mrs. Pharr, I think you were

misled, and we don't care what it says in writing here, or whether you read it or didn't read it, or assuming you read it, that you relied upon this man's representations. We decide in your favor."

Now, why should an arbitrator have a greater ability to do that than a court of law?

Ms. CALHOUN. Well, that's a very big question, and an important one, of course. And I think Mr. Guthary might be more appropriate to ask, as a legal scholar. I'm not an attorney, and I'm certainly not a scholar in this area.

But the short answer to it is that arbitrators are empowered to do equity. And they are empowered to dispense equity as they see fit, and as long as they are not acting in manifest disregard of the law. Generally, their decisions are upheld by the courts, if arbitration awards are appealed.

Senator COHEN. Mr. Westbrook, if I could direct a question to you. Mr. Diamond in this written testimony, because we gave him the 5-minute rush in the oral testimony as we say here in the Capitol, raised a practice called a sales incentive arrangement, whereby a broker can be rewarded by a free trip if he sells in sufficient volumes. That may be inconsistent with a client's best interest and he compared it, for example, to a surgeon or hospital giving a surgeon an incentive for meeting a quota with respect to a particular type of operation. Do you think that's an appropriate analogy or metaphor?

Mr. WESTBROOK. It's a very appropriate analogy, and it's a terrible practice. I happen to be fairly close to the financial planning community, although I'm not here representing them per se. I'm even on a task force within the largest body of financial planners that is setting standards for financial planners in the country. So I'm very close to the financial planning community. I also give speeches to financial planners.

Not as many years ago when limited partnerships were all the rage, they literally were doing that, they were sending people to Hawaii and doing very attractive things. They finally stopped that, but as I think even Ms. Calhoun would point out, the problem is that the investment with the greater risk has to have the greater incentive for selling. And that is not in the best interest of the consumer. The individual salesperson wants to make more money, that's what they are in the business of being in sales for. Unfortunately, it's the higher risk investment that has that higher sales incentive.

But to me, giving incentives such as that, vacations and very lucrative kinds of things, is absolutely not in the best interests of investors.

Senator COHEN. And could I ask just one final question about what you think of the SEC's proposal to eliminate the need for a written prospectus if you purchase a mutual fund, let's say, through an advertisement that you might receive through the mail or read in the paper? In other words, there is a condensed prospectus in the advertisement, and the SEC is apparently proposing, or I'm told is proposing, eliminating the requirement for a prospectus.

On the one hand we say you're bound by what you get in a prospectus, and any oral statements inconsistent with that are irrelevant in a court of law for the most part. But now, we're saying that

you don't even have to get a prospectus. So what are you bound by, the advertisement? Or are you then opening the door to say you are bound by the advertisement plus oral representations made to you. I'm not sure exactly what the rule is going to be.

But it opens up an entire new area which we haven't really dealt with here, and that is, is it a fair rule for the SEC to say "Look, we've got thousands of people out there selling these things. We can't be in a position, or the courts can't be in a position, of having to litigate every oral representation made by every salesperson or broker. Otherwise we will be in court every day."

So what do we do? Do we just go to arbitration? Is that the answer? What are we doing here? What do we need, more education?

Mr. WESTBROOK. Probably a lot of all of these things. The arbitration is a very important process, especially when it comes to brokers. I think prospectuses should always be required. I guess that's my instinct, because we have come to expect the prospectus having important data. As we gain more education, consumers will actually start to read prospectuses.

And if they cannot understand it, no matter what size print it is, they should go to a friend or someone to try to understand it. And probably the best source, if I could make a little pitch here, because people with modest means don't always have the wherewithal to come to a firm like ours, although we do handle people sometimes at lower income levels, community organizations can be very helpful. Also, there are some very good publications like Kiplingers and Money Magazine.

And if I can just tell a very brief story, my sister, who went through a divorce a number of years ago, started reading Money Magazine. And after 2 years, she said not only did she gain a great deal of confidence in matters of investments, she was able to get her life together. And I don't mean to make a pitch for a particular publication, but these publications are very objective and low cost. You don't even have to subscribe to them. You can go to the most under-utilized resource in any community, called a library, and you can learn very objectively about this very thing we're talking about through them.

Senator COHEN. You don't have any stock in Time-Warner? [Laughter.]

Mr. WESTBROOK. No, I don't. I wish I did, but no, I don't.

Mr. KAPLAN. Senator, most senior adults are much more competent than most people imagine. They have lived very difficult lives on relatively low incomes and have suffered amazing trials and tribulation in their lives. And most of them do very well on hardly any income at all.

But there is an uncontested fact, and that is that senior adults and people are living longer and longer. And this is the tip of the iceberg. As senior adults continue to live, because of better medical care and whatever, they do suffer different failings as they get older and older. And as some of them are victims, what it really means in the long run is that many of them are going to wind up in chronic care institutions.

So this has enormous ramifications, certainly with the aging population. And I think every suggestion which has been mentioned is great. But it really has to be viewed as a beginning. The prospec-

tus, and a clear prospectus is fine. But there needs to be some way of helping people understand what high risk and low risk means.

The CHAIRMAN. Mr. Kaplan, Mr. Westbrook, Ms. Calhoun, we are so indebted to you as a panel and individually. We are grateful for your testimony and for the contributions you have made to today's hearing. Senator Cohen and I are going to take all this under advisement and hopefully we can constructively move forward with some real, if not legislation, certainly a focus, a new focus, on protecting investments for the elderly, especially in this time when interest rates are low, and they are subject to scam artists and to high pressure salespersons, as we have heard about this morning.

We think this has been a very good hearing. I want to thank you, Senator Cohen.

Senator COHEN. Thank you, Mr. Chairman. Also, just before we close, I want to thank Maureen Thompson of the North American Securities Administrators Association, or NASAA, and Steve Diamond, also, from Maine, who helped us very much with this investigation.

We are going to be issuing a committee investigative report on investment fraud and abuse with some recommendations, since the securities industry itself, we think, has to do a great deal more to police itself. So we hope to have that prepared in the near future, but we thank all of you as well.

The CHAIRMAN. Thank you very much.

[Whereupon, at 12:01 p.m., the Committee recessed, to reconvene at the call of the Chair.]

# APPENDIX

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

June 17, 1993

The Honorable David Pryor
Chairman
Special Committee on Aging
United States Senate
Washington, DC 20610-6400

Dear Chairman Pryor:

Thank you for your letter of May 20, 1993, requesting the comments of the Securities and Exchange Commission ("Commission") on investment fraud that targets the elderly, and on the protection of small investors in general.

We appreciate the Committee's interest in these important issues. The Commission's mandate, defined by Congress almost sixty years ago, is to protect investors and to foster investor confidence by preserving the integrity of the U.S. securities markets. Pursuant to this mandate, the Commission administers laws and regulations governing the activities of securities firms, their registered representatives, and persons or firms that offer investment advice with respect to securities ("investment advisers" or "advisers").

The Commission views its responsibilities under the federal securities laws with the utmost seriousness. Set forth below are some of the highlights of the regulatory scheme the Commission administers, as well as some specific initiatives the Commission has recently undertaken aimed specifically at reducing investment fraud that affects small investors, including the elderly.

I. Introduction

A. Exchange Act Regulatory Scheme

Under the Securities Exchange Act of 1934 ("Exchange Act"), securities firms must register with the Commission, must comply with Commission bookkeeping, reporting, and financial responsibility requirements, and are subject to specialized anti-fraud rules. The Commission (in conjunction with the securities industry's self-regulatory organizations, or "SROs"), monitors compliance with these requirements. The Commission also inspects broker-dealers and brings administrative proceedings and civil enforcement actions against individuals and firms for violations of the federal securities laws.

In addition to regulation by the Commission, the SROs (i.e., the exchanges and the National Association of Securities Dealers, or "NASD") oversee the conduct of the securities industry pursuant to a system of "supervised self-regulation". SROs register with the Commission and exercise delegated governmental power to enforce their members' compliance with the federal securities laws. The SROs also have broad authority to adopt, administer, and

enforce their own rules, subject to Commission oversight. 1/ The Commission conducts regular oversight examinations of the activities of the SROs and their members, evaluating (among other things) SRO enforcement of securities laws and rules.

Commission and SRO rulemaking, inspections, and enforcement proceedings provide an important means of addressing sales practice abuses, and articulating and policing standards of conduct for the securities profession generally. In particular, the SROs have "know your customer" and "suitability" rules, which generally require broker-dealers to evaluate the financial circumstances and needs of their customers and to make a determination that any security recommended to a customer is "suitable" for that customer in light of the customer's financial circumstances and investment objectives.

In addition, the Exchange Act requires broker-dealers to implement adequate procedures for supervising the activities of their employees. This "duty to supervise" is an essential part of the regulatory scheme established for the protection of investors under the federal securities laws. Securities firms may be sanctioned by the Commission if they fail reasonably to supervise employees who commit violations of the federal securities statutes, or Commission or SRO rules.

B. Advisers Act Regulatory Scheme

Under the Investment Advisers Act of 1940 ("Advisers Act"), subject to certain exceptions, investment advisers must register with the Commission. The Advisers Act and Commission rules impose three types of requirements on registered investment advisers: (1) a fiduciary duty to clients; (2) disclosure provisions and anti-fraud rules designed to protect clients; and (3) recordkeeping requirements that facilitate Commission inspections of advisers.

The Advisers Act and the Commission's rules govern the types of fees that advisers can charge; the ability of advisers to engage in certain types of transactions with their clients; advertising and client solicitation practices; and client account custody practices. As fiduciaries, advisers must disclose all material conflicts of interest that they have with their clients. The Commission's rules require advisers to provide clients with a "brochure" describing the advisers' education, business background, business practices, and client fee arrangements. Additionally, advisers must disclose to clients disciplinary and financial information material to an evaluation of the adviser's integrity or ability to meet commitments to clients.

The Commission inspects investment advisers to assure that they operate in compliance with applicable law, and brings administrative proceedings and civil enforcement actions against

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1/ The SROs are required to adopt rules

> designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and communication with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . .

Exchange Act sections 6(b)(5) and 15A(b)(6).

individuals and firms for violations of the federal securities laws. There is no system of self-regulation for advisers.

II. Increased Scrutiny of Broker-Dealer Sales Practices

As you note in your letter, today's low interest rates create an environment in which small investors, many of whom are elderly, may be susceptible to investment fraud or abusive sales practices as they try to increase their rate of return on investments. The Commission is sensitive to the fact that, in such an environment, brokers may try to market more speculative investment instruments to small investors without disclosing the increased risks associated with such instruments.

In response to these developments, the Commission has taken a number of steps to strengthen the safeguards against abusive sales practices. Because broker-dealer firms are the "first line of defense" against sales practice abuses by their employees, the Commission has made special efforts to work with broker-dealers and the SROs to strengthen firms' supervisory and compliance functions. The Commission also has sought to stimulate and facilitate communication with and among broker-dealers, the SROs, and state regulators regarding trends in potentially abusive sales practices.

In the enforcement area, the Commission is bringing cases against supervisory personnel, such as branch office managers, in firms where sales practice abuses are shown to be a systemic problem and is addressing systemic supervisory problems through remedial sanctions. The aim here is not only to address the misconduct of individual employees, but also to renew, unambiguously, the message that securities firms are expected to provide for the effective supervision of their employees. The SROs, too, are bringing increasing numbers of disciplinary actions against firms with systemic sales practice problems and against supervisory personnel. Sanctions in these cases and limitations placed on business have increased in number and severity.

Finally, the SROs have made important efforts in recent years to improve the quality of information available to investors regarding the disciplinary histories of securities personnel. Pursuant to Congressional mandate, the NASD now operates an "800" number hotline which allows investors to obtain information about the disciplinary and civil liability records of broker-dealers' registered representatives. The NASD is in the process of improving the hotline by adding to its system information regarding final arbitration awards, pending NASD disciplinary actions, and pending indictments. The Commission believes that the information the hotline provides will assist small investors in protecting themselves against unscrupulous registered representatives.

III. Penny Stock Fraud

The Commission has taken specific steps to protect investors against fraud involving "penny stocks" (that is, low-priced securities traded in the over-the-counter market). In 1988, the Commission established a Penny Stock Fraud Task Force ("Task Force") in response to increasing concerns that serious violations of the federal securities laws were occurring in the penny stock market -- with elderly and other small investors most often the targets of such fraud. The Task Force has focused its efforts in the following areas: (1) increased enforcement activities, including criminal referrals when appropriate; (2) targeted regulatory solutions; (3) increased coordination and information sharing with other federal, state, local and international

regulators and prosecutors; and (4) investor education. The Commission has made significant progress in each of these areas.

The Commission brought 388 penny stock enforcement actions during fiscal years 1988-1993. The Commission's enforcement effort in this area has included an awareness that civil sanctions are not always the most effective deterrent against illegal activities in the sale of low priced securities. For this reason, penny stock activities are routinely referred to the appropriate law enforcement agencies when the conduct involved appears to warrant criminal sanctions. The Commission staff has worked closely with U.S. Attorneys' offices and the FBI, providing technical advice when requested. The Commission also has worked closely with state regulatory authorities and the NASD in carrying out the Commission's enforcement program and broker-dealer examination program efforts directed at the problem of penny stock fraud. This close coordination and cooperation between law enforcement authorities in addressing the problem of penny stock fraud has enhanced the overall effectiveness of the Task Force's work.

In 1989 the Commission adopted a new rule designed to protect investors from high pressure "cold calling" frequently used to sell penny stocks. Rule 15c2-6 under the Exchange Act requires broker-dealers selling certain low priced securities through unsolicited phone calls to obtain fundamental customer financial information, make a written suitability determination, and secure a new customer's written authorization prior to executing the transaction. 2/ In 1990, Congress passed the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Act"), which granted the Commission new enforcement powers and directed the Commission to adopt new disclosure rules to regulate the penny stock market and strengthen investor protection. In April 1992, the Commission adopted rules implementing certain provisions of the Act. 3/ These rules define what constitutes a penny stock and require, among other things, that before purchasing a penny stock, investors be given a risk disclosure document and information about the penny stock's bid and ask price, remuneration paid to the brokerage firm, and salesperson remuneration. Investors also must be given a monthly statement showing the value of penny stock holdings in their account.

In tandem with the Commission's enforcement and rulemaking efforts, the Task Force has sponsored numerous regional meetings around the country for state and federal securities regulators and prosecutors for the purpose of sharing information and discussing strategies for dealing with penny stock fraud. The Commission has also conducted securities fraud training sessions for staff from other federal and state agencies, with a view to enhancing the number of civil and criminal penny stock cases brought by other securities law enforcement authorities.

Lastly, the Commission firmly believes that one of the best tools against investor fraud is increased investor awareness. Customer complaints have always been a major source of investigative leads for the Commission. Since the creation of the Task Force, the Commission has published several brochures intended to alert investors to the types of abusive and high pressure telephone sales practices often used in connection with fraudulent penny stock sales. These brochures have been widely disseminated to thousands of investors since their publication. For example, the Commission's Miami Branch Office, in cooperation with the state of Florida, arranged for over 1.8 million copies of one of the brochures to be distributed by banks and major utility companies in Florida with their monthly account or billing statements.

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2/ Exchange Act Release No. 27160 (August 22, 1989).

3/ Exchange Act Release No. 30608 (April 20, 1992).

IV. Municipal Securities

The tremendous growth in the municipal securities market, including the growth in new products such as municipal derivative bonds, also has raised investor protection concerns. It is not clear whether the sales of more speculative municipal securities are suitable for certain unsophisticated investors.

The Commission has expressed these concerns to the Municipal Securities Rulemaking Board ("MSRB"), the self-regulatory organization responsible for drafting rules governing municipal securities dealers. Specifically, in May 1992, the Director of the Commission's Division of Market Regulation sent a letter to the MSRB recommending that it consider strengthening its customer suitability requirements for transactions in certain types of municipal securities. 4/

In response, the MSRB initiated a comprehensive study of its customer protection rules, including the suitability requirements referenced in the Division's letter. To date, the MSRB has published for comment proposals to: (1) revise its suitability rule, MSRB rule G-19, to clarify a dealer's responsibility to ensure that suitable recommendations are made to the customer; and (2) collect and publish data on the market value of frequently traded municipal securities, so as to give individual investors ready access to up-to-date municipal bond price information (providing for "market transparency"). Further action by the MSRB in this area is expected as the MSRB continues its customer protection study.

The Commission will be considering the issues arising from the MSRB study, reviewing the study's conclusions, and helping the MSRB to develop new rules, if necessary. The Commission may also propose its own rules in response to the MSRB study. In addition, in the coming months, the Commission also will undertake its own review of the regulatory framework for municipal securities. On May 24, 1993, Congressmen Dingell and Markey asked the Commission to take a comprehensive look at the present scheme of municipal securities regulation in light of the recent scandal involving the underwriting of New Jersey Turnpike Authority bonds.

V. Mutual Funds Marketed by Banks

In recent months, investors have moved large sums from low-yielding bank deposits to mutual funds, in efforts to increase their rate of return. This development, too, raises potential investor protection issues; in particular, some bank customers may mistakenly believe that mutual funds marketed by banks are federally guaranteed or insured similarly to bank deposits.

In recognition of the potential for investor confusion in this area, the Commission's Division of Investment Management recently sent a letter to all mutual funds registered with the Commission. 5/ The letter explains that it is "presumptively misleading" for a mutual fund

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4/ Letter from William H. Heyman, Director, Division of Market Regulation, Securities and Exchange Commission, to Christopher A. Taylor, Executive Director, MSRB (May 8, 1992).

5/ Letter from Barbara J. Green, Deputy Director, Division of Investment Management, Securities and Exchange Commission, to Registrants (May 13, 1993).

to have the same name as a bank that advises the fund or sells the fund's shares, or a name that is similar to such a bank ("common name fund"), because of the risk that the fund could be misconstrued by investors as being federally insured or similarly protected by the Federal Deposit Insurance Corporation ("FDIC"). The letter directs common name funds to "take immediate action" to amend their prospectuses to prominently disclose on the cover page that "shares in the fund are not deposits or obligations of, or guaranteed or endorsed by, the bank, and the shares are not federally insured by the FDIC, the Federal Reserve Board, or any other agency." Notably, the Division already requires mutual funds whose shares are sold exclusively by or through banks (regardless of their name) to provide similar disclosure on the cover page of their prospectuses. The letter now requires all mutual funds sold by or through banks (this would cover those without common names and those marketed by other entities in addition to banks) to implement similar disclosures at the time of their next filing with the Commission. The letter also cautions mutual fund registrants to ensure that their advertisements do not imply that fund shares are obligations of, or guaranteed by, a bank, or are federally insured. The Commission will continue to closely monitor this area.

VI. Risk Disclosure/Mutual Funds

Another area of ongoing concern to the Commission is that investors receive full and fair disclosure regarding the risks of their investments. The Commission is aware that your Committee is interested in this issue, and in particular, is concerned that elderly investors receive adequate and comprehensible disclosure regarding the risks of investment products that are marketed to them.

Over the past several years, in view of the marked increase in investments by small investors in mutual funds, the Commission has taken steps to make mutual fund prospectus disclosures more meaningful and less confusing. In 1988, for example, the Commission adopted rules that standardized the methods for calculating fund performance data (including yield) in advertisements and sales literature, reducing the risk that funds will be sold based on misleading and distorted performance claims.6/ More recently, the Commission adopted rule changes to make the condensed financial information presented in a mutual fund's prospectus more intelligible, and to require the prospectus to include the fund's total return. These changes also require a mutual fund to provide, either in its prospectus or annual report, a graph comparing (over a ten year period) the return on a $10,000 investment in the fund to the return on a broad-based securities index. The fund must also provide a brief explanation of its performance during the prior year. 7/

The Commission's recent proposal to permit the use of simplified prospectuses by mutual funds (also known as "off-the-page prospectuses") is likewise intended to simplify the information received by investors, without compromising the accuracy and completeness of the

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6/ Investment Company Act Release No. 16245 (February 2, 1988).

7/ Investment Company Act Release 19382 (April 6, 1993). At the same time, in order to make more information about a mutual fund's management available to investors, the Commission amended its rules to require funds to disclose in their prospectuses the identity of the individual primarily responsible for managing the fund's portfolio. Id. This requirement was widely supported by small investors, many of whom wrote to the Commission to express their support during the comment period that preceded the adoption of the rule.

disclosure. Under this rule proposal, investors would receive more detailed information about mutual funds than is provided in current advertisements, but in a more condensed and readable format than in the full prospectus. The "off-the-page prospectus" proposal is one of the recommendations made in the Division of Investment Management's report, "Protecting Investors: A Half Century of Investment Company Regulation." In preparing this report, the Division met with a number of consumer groups, many of whom expressed the concern that investors today do not read prospectuses, and suggested that investors would be better served by a short (1-2 pages) "plain English" prospectus. The proposed simplified prospectus would accomplish this objective and should benefit small, unsophisticated investors. In proposing this rule, the Commission has taken the preliminary view that by mandating disclosures about fees and risks and other key matters in short, easily comparable simplified prospectuses, investors will be able to make more informed investment decisions. The Commission is accepting comments on the proposed rule until June 23, 1993. 8/

VII. Employee Benefit Plans/Disclosure

Today, millions of American workers are being asked to fund all or part of their own retirement by building and managing investment portfolios through employer sponsored defined-contribution pension plans, such as profit sharing and 401(k) plans. Under the current regulatory structure, those entities that offer the investment vehicles available under these plans -- typically banks, insurance companies and mutual funds -- are not required to provide any information directly to plan participants. Thus, individuals investing through defined-contribution pension plans generally do not receive the same information as investors making similar purchases in the open market.

The Commission's Division of Investment Management studied this issue in its "Protecting Investors" report. To address these concerns, the report recommended that the Commission propose legislation to amend the securities laws to require the delivery of current prospectuses and shareholder reports to plan participants who select the investment alternatives offered by banks and insurance companies. Additionally, the Division recommended that the Commission amend the rules under the Investment Company Act of 1940 to require mutual funds to deliver shareholder reports directly to plan participants. The Commission is considering these recommendations.

VIII. Investment Adviser Legislation

Finally, the Commission hopes to increase substantially investor protection in the investment adviser area through a vastly improved inspection program, subject to passage of legislation to amend the Advisers Act.

In recent years, the Commission has actively supported the enactment of legislation to improve its investment advisory program. The proposed legislation was prompted by, among other things, investor protection concerns stemming from the dramatic increase in the number of investment advisers and the inability of the Commission's inspection program, due to lack of adequate resources, to keep pace with those numbers, and recent increases in fraud and abusive practices by investment advisers. In response to these concerns, investment adviser

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8/ For your information, enclosed as Attachment A is a copy of a letter that was sent to Senator Cohen of your Committee in response to concerns he expressed about this proposal.

legislation was considered in the 102nd Congress and has been reintroduced in both Houses in the current Congress. The House has already passed its bill (H.R. 578). The Senate bill (S. 423) has been referred to the Senate Committee on Banking, Housing, and Urban Affairs.

Both the House bill and the Senate bill would provide for increased fees for investment advisers registered with the Commission, to be used to supplement the Commission's existing inspection program. These fees would give the Commission critically needed resources to support an enhanced inspection program. While the largest investment advisers and advisers with custody of client assets are inspected, on average, once every three years, all others are inspected on a 28 year cycle. The additional resources would allow for a shorter inspection cycle for small advisers, with larger advisers receiving even more frequent inspections. This should permit the Commission to improve substantially its examination of investment advisers and enable it better to protect the millions of American investors, including the elderly, who, directly or indirectly, employ the services of investment advisers. Both bills also contain provisions related to adviser fidelity bonding and would give the Commission authority to participate with the states in a "one-stop" filing system for adviser registrations. 9/

* * *

Thank you again for your letter. I hope that the information we have provided will be useful to your Committee in its examination of investment fraud directed at the elderly. The Commission views with utmost seriousness its responsibilities to protect investors and prevent the abuses that undermine investor confidence. We are committed to working with Congress and other federal and state regulators and law enforcement officials to attack the problem of investment fraud against the elderly, and indeed all investors. We would be happy to assist your Committee in any way we can.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
Acting Chairman

Enclosure

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9/ Notably, the House bill contains a number of provisions that are not in the Senate bill. These provisions include an express suitability requirement, as well as increased customer disclosure regarding advisory fees and transaction costs. In addition, the House bill provides for the establishment of an 800 number that investors could call to obtain an adviser's disciplinary history.

THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON DC 20549

April 16, 1993

CHAIRMAN'S OFFICE
MAILED
APR 1 5 1993
Signed by:

The Honorable William S. Cohen
Special Committee on Aging
United States Senate
Washington, DC 20510-6400

Re: Proposed Mutual Fund Prospectus Rule

Dear Senator Cohen:

Thank you for your letter of March 23, 1993, regarding the Commission's proposal to permit the use of simplified prospectuses by mutual funds (also referred to as "off-the-page" prospectuses). We appreciate having your comments on this proposal.

You indicate that your staff on the Senate Special Committee on Aging is conducting an investigation of alleged deceptive sales tactics by some mutual fund companies on small investors, particularly senior citizens. You are concerned that the Commission proposal may exacerbate the problem of small investors being duped into making inappropriate or risky investments. You also expressed concern that the new simplified offering materials would emphasize performance without adequate disclosure of the risks of investments.

The proposed simplified prospectus is intended to provide investors a concise presentation of information important to an investment decision. Investors would receive more detailed information about mutual funds than in current advertisements, and in a more condensed and readable format than in the full prospectus. The proposed rule would require prominent disclosure of the principal risks of investment, as well as a standardized presentation of performance data, and tabular disclosure of all fees and expenses. The proposal also would require simplified prospectuses to contain approximately twenty other items of information. With this information and format, investors not only would be better able to understand a particular investment option, but they also would be able to make comparative judgments about their investment alternatives, as these prospectuses are expected to be widely circulated. The level of detail required also should preclude the use of simplified prospectuses in connection with the kind of high pressured sales pitch that takes place in many telephone solicitations.

A number of safeguards are contained in the proposal. Simplified prospectuses, unlike many mutual fund advertisements, would have the legal status of prospectuses. Fund sponsors would have "prospectus liability," as well as antifraud liability, under the federal securities laws for false or misleading statements. Several layers of monitoring and review by Commission staff and the National Association of Securities Dealers, Inc. ("NASD") are also built into the proposal. For example, funds would prefile their proposed simplified prospectuses with the Commission or the NASD for the first year of their use, permitting advance review for misleading or exaggerated claims prior to circulation. To allow for on-going Commission monitoring, every simplified prospectus also would be filed with the Commission within three days after it is first used. Investors could request the full prospectus before buying fund shares by checking a prominently displayed box. In all cases, a full prospectus would be delivered to all investors before, or with, the confirmation of sale. These and other safeguards are described more fully in the attached memorandum of the Commission's Division of Investment Management.

In your March 23 letter, you also requested a response to four specific questions about the simplified prospectus proposal. The enclosed memorandum contains more information about the proposal and responds specifically to your four questions. A copy of the proposal also is enclosed. If you require any additional information, please call Barbara Green, Deputy Director of the Division of Investment Management, at (202) 272-2045, or Matthew Chambers, Associate Director of the Division, at (202) 272-2039.

Sincerely,

Richard C. Breeden

Richard C. Breeden
Chairman

Enclosures

MEMORANDUM

April 14, 1993

**To:** Chairman Breeden

**From:** The Division of Investment Management

**Subject:** Simplified Prospectuses

This memorandum responds to Senator Cohen's letter of March 23, 1993, regarding the Commission's proposal to allow mutual funds to use simplified prospectuses (also referred to as "off-the-page" prospectuses).

The Commission proposal would amend rule 482 under the Securities Act to permit certain advertisements for mutual fund shares to include an order form if they contain certain critical information. That information would be based on requirements for the full prospectus required by section 10(a) of the Securities Act of 1933 ("section 10(a) prospectus"). The simplified prospectus would state that the section 10(a) prospectus contains more information about the fund, however, and investors could request such a prospectus by checking a prominently displayed box. Investors who do not wish to review the section 10(a) prospectus prior to investing would still receive that prospectus before, or with, the confirmation of sale. Each fund would submit its proposed simplified prospectus for advance review by the National Association of Securities Dealers, Inc. ("NASD") or the Commission for a one year period beginning with the fund's first use of a simplified prospectus.

As you know, the Commission proposed to allow the use of simplified prospectuses because it believed that their use would promote increased dissemination of information about mutual funds. Simplified prospectuses would have a more condensed and readable format than section 10(a) prospectuses, and would provide significantly more specific information than existing mutual fund advertisements. Because the rule for the first time would require the inclusion of core information in mutual fund advertisements, simplified prospectuses should provide an additional, widely circulated source of important information that investors could use to make comparative judgments about their investment alternatives. Moreover, because simplified prospectuses are prospectuses under the Securities Act, mutual fund sponsors and sales representatives using simplified prospectuses would be subject to liability that should promote fair, complete, and accurate disclosure.

Our responses to Senator Cohen's four questions are set forth separately below.

**1. What is the timeframe for implementation of this rule?**

There is no specific timetable for implementing the rule. The public comment period closes on June 23, 1993. At that time, the Commission will assess the comments and determine whether or not to adopt a final rule. The length of this process will depend upon the nature and number of the comments received, but any final Commission action is unlikely to occur before late summer. The effective date of the final rule also may depend on whether the NASD must make any changes to its Rules of Fair Practice to implement procedures for review of simplified prospectuses. If the NASD must amend its rules, the simplified prospectus rule probably would not go into effect until those amendments are final; under section 19(b) of the Securities Exchange Act of 1934, there must be a period of notice and comment before the Commission approves changes to the NASD's rules. This process could take several months.

**2. In developing this rule, how were issues concerning the protection of small, unsophisticated investors addressed? How does this rule affect investor protection mandates as outlined in the Investment Company Act of 1940?**

The proposed disclosure and format requirements address the concerns of small investors by requiring concise presentation of information that investors would find important to an investment decision. The rule would require simplified prospectuses to include twenty-one items of specific information about the fund, including the following: type of fund (*e.g.*, money market fund); fees and expenses (in tabular form); standardized historical performance data; portfolio turnover rate; investment objectives and policies; principal risk factors; options for receiving dividends and distributions; tax consequences; purchase procedures; minimum initial and subsequent investment amounts; the purpose of asset based distribution fees, if any; restrictions upon redemptions; minimum account balances; and material pending legal proceedings. In addition, if the fund imposes front-end or back-end sales charges, the simplified prospectuses must also include a clear prominent statement of the consequences of those loads.

Such information would be presented in a concise, easily readable manner. Investors would not only be better able to understand a particular investment option but would also be able to make comparative judgements about their investment alternatives since these prospectuses are expected to be widely circulated.

Certain information that appears in the section 10(a) prospectus would not be required in a simplified prospectus. For example, the proposal would not require information about the responsibilities of the fund's board of directors; all the providers of administrative services; the name and address of the transfer agent and dividend paying agent; information about how to make shareholder inquiries; the name and address of the underwriter; an explanation of how the fund determines the public offering price; or complete details about special purchase plans or redemption procedures. Investors would receive that information in the section 10(a) prospectus, which they would receive no later than the confirmation of any purchase. Moreover, investors always could request the section 10(a) prospectus at any time: the proposal would require simplified prospectuses to contain a prominent legend stating that the section 10(a) prospectus is available free upon request and that investors who are not familiar with mutual funds may wish to obtain that prospectus before investing. The order form would be required to include a box investors could check to request the section 10(a) prospectus.

The proposal comes out of a report issued last year by the Commission's Division of Investment Management, *Protecting Investors: A Half Century of Investment Company Regulation*. In preparing the report, the Division met with a number of groups, including consumer groups. Many people expressed the concern that investors today do not read prospectuses. Representatives of one group told the Division that their members would be better served if the Commission could devise a short (1-2 pages) "plain English" prospectus. The proposed simplified prospectus would accomplish this objective and should benefit small, unsophisticated investors.

The proposed rule would not be available to certain investment companies with which small investors generally are not familiar or whose disclosure may be overly complex, such as closed-end companies and unit investment trusts. The exclusion of unit investment trusts means that the rule could not be used for periodic payment plans. In addition, only funds that have been in existence at least two years from the first public sale of their shares would be eligible to use simplified prospectuses.

Thus, the simplified prospectus rule would fulfill the investor protection mandates outlined in the Investment Company Act of 1940. Section 1(b)(1) of the Investment Company Act articulates a policy that investors be able to purchase securities with "adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management." The Commission believes that this policy is satisfied by the extensive information requirements of the proposal, the requirement that any fund using the rule have been in operation for at least two years, the procedures for review by the Commission or the NASD, and the liability for misleading statements under various provisions of the securities laws (discussed below).

3. **What safeguards exist to prevent abuses resulting from overly simplistic marketing programs? How did the SEC take into account requests from State Securities Administrators that disclosure be enhanced in order to curtail the surge in sales practice abuses?**

The Federal securities laws contain several safeguards against misleadingly simplistic statements and thus should ensure fair and complete disclosure in simplified prospectuses. Simplified prospectuses, like other mutual fund advertisements complying with rule 482, would subject fund sponsors to "prospectus liability" for false or misleading statements of material fact under section 12(2) of the Securities Act. They also would carry liability for fraud under section 17(a) of the Securities Act and section 10(b) of the Securities Exchange Act, including rule 10b-5.

In addition, the proposal provides for several levels of review and monitoring to guard against misleading disclosure. First, simplified prospectuses would contain only information the substance of which is included in the fund's section 10(a) prospectus. Thus, the Commission staff would have had the opportunity to review the information in the course of reviewing the fund's registration statement (which includes the section 10(a) prospectus). Second, each fund would pre-file simplified prospectuses with the Commission or the NASD for a period ending one year after the fund's first use of any simplified prospectus. The NASD examiners already review many rule 482 advertisements to ensure, among other things, that they are not misleading or contain exaggerated claims. Finally, simplified prospectuses would be filed with the Commission no later than three days after the prospectus is first used, thereby permitting the Commission to monitor compliance with the rule.

It is unlikely that other, overly simplistic marketing materials would be mailed with simplified prospectuses. The Securities Act effectively would prevent the inclusion of most other sales literature in mailings with simplified prospectuses.[1] Thus, investors could not be lured into purchasing through simplified as a result of accompanying sales literature that provides misleading information about the fund.

The views of the North American Securities Administrators Association ("NASAA") received careful attention in the consideration of the proposal. In particular, NASAA expressed concern that important information might shrink and "drift" from simplified

[1] The Securities Act of 1933 prohibits mailing such materials unless they are preceded or accompanied by a section 10(a) prospectus Thus, they could not accompany or precede a simplified prospectus, unless a section 10(a) prospectus had already been sent

prospectuses; NASAA also observed that "disclosure drift from the prospectus to the [statement of additional information] can be controlled by careful regulatory review." The Commission and the NASD will scrutinize simplified prospectuses to guard against such "drift."

4. **Finally, in formulating the proposed rule, what considerations were made to ensure that inexperienced investors were fully aware and informed of the risks of investment and to secure protection for them from patently abusive or fraudulent offerings?**

The proposal is designed to ensure that investors receive meaningful disclosure about the risks of investing in a fund. The risk disclosure would be prominently displayed next to the discussion of the investment objectives and policies. In addition, the Commission specifically requested comment on whether the Commission should require the simplified prospectus to contain some form of standardized presentation of the degree and kind of risks presented by the fund relative to another fund. For example, a fund could describe in the prospectus where it thinks it fits on a risk continuum from low risk (*e.g.*, a money market fund) to high risk (an emerging market country fund), or on a numerical scale from 1 (least risky) to 10 (most risky).

Senator Cohen's letter also voiced a related concern that simplified prospectuses might "overly emphasize performance without adequately disclosing the inherent risks of such investments to small investors." Under the proposal's requirements for performance disclosure, simplified prospectuses should not be able to emphasize performance without adequately disclosing the inherent risks of such investments. First, the rule would require that any disclosure of performance information include yield and/or total return for specified periods and computed according to standardized formulas; under the existing provisions in rule 482 regarding the presentation of performance data, such data must be accompanied by a legend discussing the limitations of the displayed performance data. Second, the Commission requested comment whether, in order to control "hyping" of fund performance, the rule should restrict the format of presentations of performance figures, for example by limiting the use of footnotes in disclosure of performance, fees and expenses. Third, off-the page prospectuses would be required to include clear disclosure of the risks of investing in a fund.

In formulating the proposal, the Division and the Commission gave careful consideration to protecting against patently abusive or fraudulent offerings; the rule as proposed includes several important safeguards. First, simplified prospectuses would have the status of prospectuses meeting the requirements of section 10(b) of the Securities Act of 1933. As discussed above, all simplified prospectuses would subject fund sponsors to liability under the Securities Act and the Securities Exchange Act for false or misleading statements. Second, the proposal requires filing of copies of simplified prospectuses with the Commission and the NASD to provide for review and monitoring. These provisions should deter sponsors who might be tempted to use simplified prospectuses for abusive or fraudulent offerings.

# NASAA

# INVESTOR BULLETIN

## HOW OLDER AMERICANS CAN AVOID INVESTMENT FRAUD AND ABUSE

Older Americans are the No. 1 target of investment con artists. Additionally, stockbrokers and financial planners who engage in abusive practices often seek out the elderly. The files of state securities agencies are filled with tragic examples of senior citizens who have been cheated out of savings, windfall insurance payments and even the equity in their homes. Fortunately, such victimization can be avoided by following 10 self-defense tips developed for older Americans by the North American Securities Administrators Association (NASAA), which, in the U.S., is the national voice of the 50 state securities agencies responsible for investor protection at the grassroots level.

1. *Don't be a "courtesy victim."* Older Americans are of the generation that was taught to be courteous at all times to phone callers, as well as people who visit them at home. Con artists will not hesitate to exploit the "good manners" of a potential victim. Remember that a stranger who calls and asks for your money is to be regarded with the utmost caution. **You are under absolutely no obligation to stay on the telephone with a stranger who wants your money.** In these circumstances, it is not impolite to explain that you are not interested and hang up the phone. Save your good manners for friends and family members, not swindlers!

2. *Check out strangers touting "strange" deals.* Trusting strangers is a mistake that all too many older Americans make when it comes to their personal finances. **Say "no" to any investment professional or con artist who presses you to make an immediate decision, giving you no opportunity to check out the salesperson, firm and the investment opportunity itself.** Extensive background information on investment salespeople and firms is available from the Central Registration Depository (CRD) files available from your state securities agency (call NASAA at 202/737-0900 for the number) or the National Association of Securities Dealers (1-800/289-9999). Almost all investment opportunities must be registered for sale in the state in which you live. Your state securities agency can tell you if the investment opportunity is properly registered. Before you part with your hard-earned savings, get written information about the investment opportunity, review it carefully and make sure that you understand all of the risks involved.

   A favorite tactic of telemarketing con artists is to develop a false bond of friendship with older Americans. Swindlers know that many senior citizens are eager to have someone to talk to on the phone ... even if that someone is a complete stranger. If you are dealing in person with a stockbroker or financial planner, do not be swayed by offers of unrelated advice and assistance that are merely efforts to develop a sense of friendship and even dependency. **If you are lonely and in need of companionship, don't make the mistake of seeking it from someone whose only real interest is to get his or her hands on your money.**

3. *Always stay in charge of your money.* A stockbroker, financial planner or telemarketing con artist who wants your money will be more than happy to assure you that he or she can handle everything, thereby relieving you of the need to watch over and protect your nest egg. Beware of any financial professional who suggests putting your money into something you don't understand or who urges that you leave everything in his or her hands. **Constant vigilance is a necessary part of being an investor.** If you understand little about the world of investments, take the time to educate yourself or involve a family member or a professional, such as your banker, before trusting a stranger who wants you to turn over your money and then sit back and wait for results.

4. *Never judge a person's integrity by how they "sound."* All too many older Americans who get wiped out by con artists later explain that the swindler "sounded like such a nice young man (or woman)." Successful con artists sound extremely professional and have the ability to make even the flimsiest investment deal sound as safe and sound as putting money in the bank. Some swindlers combine professional-sounding sales pitches with extremely polite manners, knowing that many older Americans are likely to equate good manners with personal integrity. Remember that the sound of a voice (particularly on the phone) has no bearing on the soundness of an investment opportunity.

5. *Watch out for salespeople who prey on your fears.* Con artists know that many older Americans worry that they will either outlive their savings or see all of their financial resources vanish overnight as the result of a catastrophic event, such as a costly hospitalization. As a result, it is common for swindlers and abusive salespeople to pitch their schemes as a way for older Americans to build up their life savings to the point where such fears are no longer necessary. Remember that fear and greed can cloud your good judgment and leave you in a much worse financial posture. An investment that is right for you will make sense because you understand it and feel comfortable with the degree of risk involved.

6. *Exercise particular caution if you are an older woman with no experience handling money.* Ask a con artist to describe his ideal victim and you are likely to hear the following two words: "elderly widow." Sadly, many women who are now in their retirement years often received in their youth little or no education about how to handle money. Women of this generation often relied on their husbands to handle most or all major money decisions. As a result, older women (particularly those who have received windfall insurance payments in the wake of the death of a spouse) are prime targets for con artists. Elderly women who are on their own and have little know-how about handling money should always seek the advice of family members or a disinterested professional before deciding what to do with their savings. One excellent resource available nationwide is the Women's Financial Information Program at the American Association of Retired Persons (AARP). For more information, call (202)434-6030, or write "Women's Financial Information Program," AARP, Consumer Affairs, 601 E Street, NW, Washington DC 20049.

7. *Monitor your investments and ask tough questions.* Too many older Americans not only trust unscrupulous investment professionals and outright con artists to make initial financial decisions for them, but compound their error by failing to keep an eye on the progress of the investment. Insist on regular written and oral reports. Look for signs of excessive or unauthorized trading of your funds. Do not be swayed by assurances that such practices are routine or in your best interests. Do not permit a false sense of friendship or trust keep you from demanding a return of your savings. When you suspect that something is amiss and get unsatisfactory explanations, call your state securities agency and make a complaint.

8. *Look for trouble retrieving your principal or cashing out profits.* Many older Americans have little ongoing need for invested funds, while others need returns that are paid out to them regularly in order to supplement limited incomes. If a stockbroker, financial planner or other individual with whom you have invested stalls you when you want to pull out your principal or even just profits, you may have uncovered someone who wants to cheat you. Since unscrupulous investment promoters pocket the funds of their victims, they often go to great lengths to explain why an investor's savings are not readily accessible. In many cases, they will pressure the investor to "roll over" non-existent "profits" into new and even more alluring investments, thus further delaying the point at which the fraud will be uncovered. If you are not investing in a vehicle with a fixed term, such as a bond, you should be able to receive you funds or profits within a reasonable amount of time.

9. *Don't let embarrassment or fear keep you from reporting investment fraud or abuse.* Older Americans who fail to report that they have been victimized in financial schemes often hesitate out of embarrassment or the fear that they will be judged incapable of handling their own affairs. Some senior citizens have indicated that they fear that their victimization will be viewed as grounds for forced institutionalization in a nursing home or other facility. Recognize that con artists know about such sensitivities and, in fact, even count on these fears preventing or delaying the point at which authorities are notified of a scam. While it is true that most money lost to investment fraud is rarely recovered beyond pennies on the dollar, there also are many cases in which older Americans who recognize early on that they have been misled about an investment are then able to recover some or all of their funds by being a "squeaky wheel." A good resource for older Americans who fear that they have been victimized

is the securities agency in the state in which they live. For the telephone number and address of your state securities agency, contact NASAA at 202/737-0900.

10. ***Beware of "reload" scams.*** Younger Americans who are ripped off by swindlers are fortunate to the extent that they have the opportunity to pick themselves up and restore some or all of their losses through new earnings. However, most older Americans are dealing with a finite amount of money that is unlikely to be replenished in the event of fraud or abuse. **The result is a panic that is well known to con artists, who have developed schemes to take a "second bite" out of senior citizens who already have been victimized.** Faced with a loss of funds, some senior citizens will go along with another scheme (allowing themselves to, in effect, be reloaded) in which the con artists promises to make good on the original funds that were lost ... and possibly even generate new returns beyond those originally promised. Though the desire here to make up lost financial ground is understandable, all too often the result is that unwary senior citizens lose whatever savings they have left in the wake of the initial scam.

*Additional quantities of this document*
*are available at no cost*
*by calling 202/737-0900.*

*Or write:*
*"Older Americans and Investment Fraud,"*
*North American Securities Administrators Association*
*One Massachusetts Avenue NW, Suite 310*
*Washington DC 20001*

LAW OFFICE OF
DAVID E. SHELLENBERGER
185 DEVONSHIRE STREET
BOSTON, MASSACHUSETTS 02110

TELEPHONE: (617) 482-4840
TELECOPIER: (617) 482-6676

June 15, 1993

United States Senate
Special Committee on Aging
The Honorable David H. Prior, Chairman
Washington, DC 20510-6400

Re: "How Secure Is Your Retirement: Investments, Planning and Fraud?"

Dear Senator Prior and Members of the Committee:

This submission is made in connection with the hearing held on May 25, 1993.

I am an attorney in private practice in Boston, Massachusetts. I concentrate in representing investors in claims against brokerage firms.

Many of my clients are elderly. In fact, my typical client is a widow in her 70's, often an immigrant, who has lost 50-100% of her savings through broker misconduct.

The most common types of misconduct are unsuitability (inappropriately risky investments), churning (excessive transactions intended to generate commissions), and fraud.

I believe the elderly are disproportionately victimized by the brokerage industry for two reasons. First, the elderly's accumulated savings attract brokers. Second, the elderly grew up in a time when people could be more trusting of business people, and thus lack appropriate skepticism in connection with investments.

I believe that one answer to the problem is for the Securities and Exchange Commission to maintain pressure on the "self-regulatory organizations" such as the New York Stock Exchange and the National Association of Securities Dealers a) to require the brokerage industry to properly supervise the handling of accounts, and b) to weed out the many brokers who remain in the industry despite poor compliance records.

I appreciate your concern regarding this problem.

Thank you very much.

Very truly yours,

David E. Shellenberger

DES/mcf

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